TAX ASPECTS OF ACQUISITIONS AND MERGERS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

AND

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

APRIL 1, 2, AND 16, 1985

Serial 99-27

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TAX ASPECTS OF ACQUISITIONS AND MERGERS

MONDAY, APRIL 1, 1985

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT, AND
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The subcommittees met, pursuant to call, at 10:05 a.m., in room 2175, Rayburn House Office Building, Hon. J.J. Pickle (chairman of the Subcommittee on Oversight) and Hon. Charles B. Rangel (chairman of the Subcommittee on Select Revenue Measures) presiding.

[Press releases announcing the hearings follow:]

[For immediate release Friday, March 8, 1985]

HON. DAN ROSTENKOWSKI (D. ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A HEARING ON THE TAX ASPECTS OF ACQUISITIONS AND MERGERS

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee on Oversight, in conjunction with the Subcommittee on Select Revenue Measures, will conduct a hearing to examine the tax aspects of mergers and acquisitions. The hearing will be held on Monday, April 1, 1985, beginning at 1:30 p.m. and Tuesday, April 2, 1985, beginning at 9:30 [1] a.m., in Room B-318, Rayburn House Office Building, Washington, D.C.

In announcing the hearing, Chairman Rostenkowski stated, "With increased Congressional concern over the number and content of recent acquisitions and mergers, it is important that we have a clear understanding of the importance and role of the various tax provisions in corporate merger and acquisition decisions. The large number of recent mergers and acquisitions raise national issues that deserve thoughtful analysis."

The Subcommittee on Oversight will invite witnesses to testify about the degree to which the tax code influences merger and acquisition decisions by providing tax benefits upon a change in ownership of a corporation which would not be available absent the change. Among other tax provisions, the Subcommittee will consider the availability of loss carryovers and other tax attributes following an acquisition, and the ability of a purchaser corporation to step-up the basis of the acquired corporation's assets for purposes of depreciation and depletion deductions, with only limited "recapture" income being taxed to the acquired corporation. In addition, the Subcommittee intends to examine the role of other tax provisions which, while they may not be available only in a merger or acquisition situation, may have an effect on corporate acquisitions. Included will be consideration of the deductibility of interest on debt used to finance leveraged buyouts and other acquisitions, and the use of installment obligations and Employee Stock Ownership Plans in connnection with acquisitions. The Subcommittee will also request testimony reviewing the economic impact of mergers and acquisitions, including their effects on productivity, employment, and technological advance.

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[1] Subsequently changed to 12 noon.

Chairman Rostenkowski further noted that the Subcommittee on Select Revenue Measures is currently examining the rules governing the carryover of net operating losses and other tax attributes in anticipation of the year-end expiration of the deferred effective date of the 1976 Tax Reform Act rules. This hearing is designed to complement those efforts. The Subcommittee's consideration of specific proposals to limit net operating loss carryovers will be deferred until a later date.

[For immediate release Friday, March 22, 1985]

HON. DAN ROSTENKOWSKI (D. ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A CHANGE IN SCHEDULE FOR THE SUBCOMMITTEE HEARINGS ON THE TAX ASPECTS OF ACQUISITIONS AND MERGERS

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the time and place of the Subcommittee on Oversight hearings, held in conjunction with the Subcommittee on Select Revenue Measures, on the tax aspects of acquisitions and mergers have been changed and, in addition, a day has been scheduled to receive oral testimony from public witnesses.

The hearing scheduled for Monday, April 1, 1985, beginning at 1:30 p.m. in Room B-318 Rayburn House Office Building will now be held at 10:00 a.m. in Room 2175 Rayburn House Office Building. The second day of hearings scheduled for Tuesday, April 2, 1985, beginning at 9:30 a.m., in B-318 Rayburn House Office Building will now be held in Room 1100 Longworth House Office Building. In addition, a third day of hearings has been scheduled for Tuesday, April 16, 1985, beginning at 10:00 a.m. in Room 1100 Longworth House Office Building, to receive oral testimony from public witnesses requesting to be heard.[1]

All other details concerning this hearing remain the same (see Press Release #5, dated March 8, 1985).

Details for submission of requests to be heard.—Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler [(202) 225-3627] no later than Tuesday, April 9, 1985, to be followed by a formal written request to Joseph K. Dowley, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 100 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearances.

Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

Requests to be heard, prepared statements to be presented in person, and statements filed for the printed record of the hearing, must contain the following information:

1. The name, full address, and capacity in which the witness will appear, as well as a telephone number where the witness or a designated representative may be reached;
2. A list of any clients or persons, or any organization for whom the witness appears; and
3. A topical outline or summary of comments and recommendations.

Written statements in lieu of personal appearance.—Persons submitting written statements for the printed record of the hearings should submit at least six (6) copies by the close of business, Tuesday, April 30, 1985, to Joseph K. Dowley, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Long-

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[1] Subsequently changed to 12 noon.

worth House Office Building, Washington, D.C. 20515. (See other requirements enumerated above.) If those filing written statements for the record of the printed hearings wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office before the hearing scheduled for April 16 begins.

Chairman PICKLE. The Chair will ask the subcommittee to please come to order. And if possible, we would like to ask our guests to take a seat. We have one or two members in route to appear here with the committee, but in the interest of time, we are going to proceed.

I am glad that Senator Boren is here now.

The Chair is going to make an opening statement, and then will yield to the ranking members to make any additional statement.

We have several witnesses today and a very full schedule tomorrow, so we will proceed as quickly as we can. I will proceed now with my initial statement.

Today we are beginning a series of hearings on the role of the tax code in corporate mergers and acquisitions.

Corporate mergers have become the hottest game in American business. Whether it is one Goliath consuming another or a David consuming a Goliath, these multibillion-dollar transactions call for close scrutiny on the tax aspects of these activities.

With the dramatic increase in the number and value of corporate mergers in recent years, a debate has been raging over whether this is good or bad for our economy. Much of the attention is focused on hostile takeovers.

Personally, I have a hard time believing that there are millionaires and billionaires all over the country staying up late each night out of the goodness of their hearts to think of ways to help mom and pop stockholders get a better deal from corporate management.

Are these just modern day Robin Hoods leading a campaign for stockholder rights? Or are they fast-buck artists who abandon their crusades and their populist principles at the first mention of greenmail?

Have the raiders brought more efficiency and productivity to corporate America, or have they frightened inept and bloated management to further entrench itself through poison pills and shark repellant?

There are deep divisions over whether all of this is healthy or harmful.

According to one administration official in recent testimony, takeovers perform a number of valuable functions such as freeing up capital for new investment, reallocating resources to better uses and reinforcing market incentives for efficient management.

Critics, on the other hand, have pointed to the loss of jobs, the disruption of communities, the decline in long-term research and development and massive corporate debt that is not directed toward productive investment.

It appears that the administration is taking a hands-off approach to this issue. We hope that we will have direct testimony from them shortly.

So why should Congress get further involved in the relationship between stockholders and management?

Well, when anything affects Federal revenues, this committee and this chairman become very concerned.

When I read that a group of investors receive a $100 million greenmail windfall, I can't help but wonder how much of that was paid in taxes.

When two industrial giants merge to head off a potential raider, I want to know how their new tax level compares to the taxes they paid before the merger.

When management takes a $500 million tax deduction for greenmail payments, I want to know how those can be justified as an ordinary and necessary expense.

When $14 billion in high-interest junk bonds are dumped on the market, I want to know whether income taxes on interest received is balancing against the interest deductions that are claimed.

When billions of dollars are quickly changing hands in these high-stakes games, my suspicion is that there is a chipmunk in the woodpile somewhere, and we intend to flush it out.

My instincts tell me that when the dust settles after a big takeover battle, the big winners are the greenmail extortionists, the Wall Street arbs, the junk bond merchants and top management, floating to a soft landing under a golden parachute. Among the losers is the Federal Treasury.

From these hearings, I want to find out to what degree Congress has aided and abetted this merger mania through the Tax Code. We may well find that the answer goes to the very heart of how we tax corporations in this country. But wherever the trail leads, we intend to follow it to its conclusion.

Now the Chair would like to recognize Chairman Rangel for any statement that he might make at this point.

This is a joint hearing between the Oversight Subcommittee and the Select Revenue Measures Subcommittee, because the Select Revenue Measures Subcommittee has been conducting for some time an in-depth study with respect to net operating losses.

I recognize Chairman Rangel.

Chairman RANGEL. I am certain that the new chairman of the Oversight Committee has already stated the case for this joint effort.

We want to make certain that the Treasury Department is not losing revenue which we certainly need.

We also want to make certain that these mergers are done for sound business reasons rather than to just rip off the system.

I am convinced that the Congress and this committee will learn a lot. If remedial legislation is necessary, we are prepared to do it.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Schulze, the ranking Republican member, would you care to make a statement?

Mr. SCHULZE. My interest in corporate acquisitions was perhaps heightened in recent years by the activity surrounding the Gulf Oil Co., which is based in Pennsylvania.

As we all know, Gulf was eventually acquired. The activity surrounding Gulf made me quite aware of the various tax and nontax problems raised by corporate acquisitions, particularly those involving larger corporations.

Despite this awareness, it is not entirely clear to me that any Federal action will correct or even cure potential problems generated by these acquisitions. For example, some type of State corporate law changes may be more appropriate than Federal action.

In the area of tax policy, we can, of course, restrict tax benefits obtained in specific types of corporate acquisitions. However, restrictions of this type may do rough justice at best, since they require the committee to taint prematurely various types of transactions while approving others.

The matters of individual transactions are not considered under this approach. Transactions undertaken for sound business reasons thus could be prevented.

The subcommittees have invited a very knowledgeable group of witnesses to these hearings. Their views no doubt will prove to be of great assistance in understanding the field of mergers and acquisitions.

This understanding will allow us then to determine the types of legislation which may be appropriate for this committee to consider, and I look forward with interest to hearing them, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Schulze.

Mr. Thomas.

Mr. THOMAS. The questions that the chairman posited in his opening statement, I think, are valid ones, but as usual, not everything is bad or good.

We should prevent the bad without stultifying the good, and chipmunks in the woodpile are not what government should be about. Skunks are a different matter.

I hope the hearings will find out whether the stripes are along the sides of this critter or down its back.

Chairman PICKLE. At the risk of being "one-upped" again, who seeks to be recognized?

Mr. FLIPPO. Mr. Chairman, I have a statement, but in the interest of time, I would like to file it for the record.

Chairman PICKLE. Thank you. That will be entered into the record.

[The statement follows:]

OPENING STATEMENT OF HON. RONNIE G. FLIPPO

Thank you Mr. Chairman.

I want to commend you Mr. Chairman, and Mr. Rangel for holding these hearings on mergers and acquisitions.

The recent wave of mergers and acquisitions is a source of concern to many Americans. This concern is not only confined to the management, shareholders and communities directly affected by the merger activities. The trends are troubling to everyone concerned about the impact of a high level of merger activity on the economy of the country.

Some dismiss the concerns with the jargon and rhetoric of economic theory suggesting that the high level of mergers is no more than the workings of free enterprise leading to greater efficiency and penalizing poor management.

This may be the case, but we must remember that our economy is not characterized by perfect competitions. Our system of free enterprise is tempered by the influence of government and other institutions and to no small extent by the tax structure.

Many of us here today may recall the feverish merger activities of the 1960's when billions of dollars exchanged hands in the formation of huge conglomerates. Just as now, the new forms of corporate organizations were justified in the terms of

free enterprises. The prevailing theory of that time suggested that the management team successful in one industry could easily be transferred to another and the overall efficiency of the economy would be enhanced. This idea of synergism that the sum would be greater than the whole has not stood the test of time. Far too many corporations have wasted far too much money and energy in undoing the results of the merger fever in the sixties.

The circumstances are different now, but, once again, we are seeing the diversion of billions of dollars and the energies of some of the brightest minds in our society to the pursuit of takeovers and away from more productive endeavors.

The hearings we are beginning here to day should help us understand the factors underlying the trends now underway in our economy. These hearings are a timely and prudent response to a perplexing and complex set of issues. Mr. Chairman, I commend you for your leadership in arranging these hearings and focusing the attention of the House on this important subject area.

[By subsequent unanimous consent, the following was entered into the record:]

OPENING STATEMENT OF HON. GUY VANDER JAGT

Thank you Mr. Chairman, The hearings we are holding on Mergers and Acquisitons are very timely in my judgement. It appears as though the acquisitions in the energy field have subsided and a new interest in acquiring communication companies has started. Thus, the topic of mergers and acquisitions is still very current.

As the Members may recall, this Committee over the years has considered in great depth the tax rules relating to merger and acquisitions. For the most part, we have considered these rules during periods on merger and acquisition activity, with a view toward correcting or eliminating the tax abuses associated with the mergers and acquisitions taking place at that particular time. After these efforts, new forms of mergers and acquisitions seem to be utilized that are consistent with our new rules. For example, the 1982 Act contained detailed rules relating to various types of corporate acquisitions. Despite these rules, we are here today again considering corporate acquisitions.

In my judgement, the Committee's frequent review of corporate acquisitions is caused by the complicated issues these acquisitions raise. Some of these issues may go beyond this Committee's jurisdiction—anti-trust, Federal monetary policy, state and local government finances, corporate finance and state regulation of corporations.

With our background on corporate acquisitions and the assistance of the invited witnesses, I'm sure the Committee will be able to fully study the current, and possibly some future, forms of corporate acquisitions. This will allow the Committee to determine if any corrective legislation is required.

Chairman PICKLE. We will proceed. We are pleased to have with us our first witness, the distinguished Senator from Oklahoma, Hon. David Boren.

He has been involved in this question in recent days because of the threatened takeover of a company in his State, and as a result, has spent a great deal of time on this particular question.

We are pleased that you are with us, Senator.

STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator BOREN. Thank you very much. I appreciate this opportunity.

I have already enjoyed the discussion, both the biological, zoological, as well as the tax discussion that has preceded, and I want to commend both groups for calling these hearings to examine what I think is a very, very important problem.

While much has been said about the ill effects of corporate mergers, it would be wrong to suggest that all mergers are bad. Many voluntary mergers have combined research resources and market-

ing capabilities to enhance the ability of the new unit to compete in the world markets.

With the ever-increasing interdependence among U.S. and the world economies, we can no longer afford to take just a domestic view. We must recognize the importance of our ability to compete abroad and we must not underestimate the contribution to that effort that voluntary mergers can make under appropriate circumstances.

It is also true that not all hostile mergers are bad. Sometimes an ineffective management team needs to be replaced. Where the management has not done enough to maximize stock performance and a more efficient use of corporate resources is available, hostile corporate takeovers may help accomplish these tasks to the benefit of the stockholders and the economy at large.

Therefore, while there are problems with corporate mergers that need our attention, we must be careful in crafting a remedy to target the abuses while not preventing the legitimate economic activity, to which I have referred. We must interfere with the free market as little as is possible.

While I acknowledge that mergers can in some instances be helpful, the economic justification for two-tier hostile takeovers is more difficult to establish since the same offer is not extended to all stockholders. It is hard to see how all stockholders could be said to benefit when a few stockholders receive higher prices for their stock than the average stockholder.

It is also hard to see how it could be said that all stockholders are benefited when a small group of stockholders, by threatening a takeover, receive what is commonly called greenmail payments for the stock they may end up holding for only a very short period of time. These are payments which other rank and file stockholders do not receive.

We have seen many examples of this where the so-called greenmail payments are made and a small group of stockholders get a much higher price for their stock than do the rest of the stockholders.

It is difficult to understand how it is in the long-range best interest of the country for this to happen, particularly when one considers that such payments use cash that could better be used for research and development, modernization of plant, or other investment purposes which are critical to our remaining competitive. Instead, the cash is diverted to speculators who have no interest in the long-range productivity of the company.

Business investment priorities are further distorted by merger activity of this kind. Not only are the alternative uses of cash skewed, but so is the ability to borrow. While a target company may want to borrow for expansion, its creditors will limit how much they loan based on the perceived ability to repay from anticipated cash flow.

On the other hand, those who attempt to take over that very same corporation may be able to get their creditors to stretch the value of the target balance sheet much further since liquidation value rather than the anticipated cash flow is the critical factor. This is clearly the situation.

There I mean that they look at the liquidation value of that company, they may be willing to make very generous loans, sometimes through the junk bond financing route, but in the case of a company that is trying to get additional credit in order to expand its own research and development and improve its long-range competitiveness, they have a hard time getting it, because the cash flow of that company is not able to demonstrate repayment quite as quickly as selling off the junk bonds.

Use of so-called junk bond financing where the loan is secured only by the anticipated value of the assets of the target company is also very questionable in situations where used in a two-tier hostile takeover attempt or where used to leverage a greenmail threat.

In the recent stock play by Carl Icahn against Phillip's Petroleum Co., it was clearly contrary to the national interest, the interest of the company, its stockholders, and employees, for the greenmail payment to have been brought about by the leverage power of junk bonds.

Even if Icahn had used the junk bond route to prevail in the takeover, instead of merely to achieve the greenmail payments, which he will achieve, it would still not serve the national interest because the company would, of necessity, have been dismantled to retire the debt. The cannibalization would occur without concern for the well-being of the community, the employees and their families, the retirees, or the long-range impact on domestic energy production.

It is particularly inappropriate that the Tax Code is not even neutral in these situations but rather it appears to encourage greenmail and takeovers by junk bond financing by: One, allowing the deductibility of the interest expense; two, stepping up the basis of assets acquired; and three, allowing the potential for lower tax rates on appreciated stock by giving it capital gains treatment.

If you obtain greenmail through these situations, you have stock, let's say, for 3 or 4 months, you leverage this kind of situation; buy stock at 40 and, all of a sudden, sell it at 55 or 60 after leveraging this greenmail, you are not even taxed on it as ordinary income. You could convert that income into capital gains. Or, if you succeeded in taking over a company and had to sell it off in order to pay back the junk bonds, which are secured only by the assets of the target company, you acquire a stepped-up basis and don't have a full taxable except on the difference of the assets of the company in an earlier period, on the company's own tax liability sheet.

The current climate affects not only those associated with companies already taken over and those not at play, but also all companies who may anticipate attack. Uncertainty on their part has been the impetus for defensive actions which are designed either to make the company unattractive to a possible purchaser by overburdening the healthy company or to make short-term profit a priority over long-term productivity so as to get the price of the stock up too high to continue to be attractive as a possible takeover target. Neither reaction bodes well for the future economic health of our country.

I know the Finance Committee, the Ways and Means Committee, the Joint Economic Committee have all been urged by corporate

leaders to take the longer view, engage in research and development that will make the company good in the long view.

As they become takeover targets, they have to concentrate on getting short-term profitability up to avoid the takeover attempt. We encourage them to take on heavy debt burden to make themselves less attractive also.

In summary, while we want to stop the abuses and ill effects of two-tier hostile corporate takeovers, we must be careful to take a rifle shot approach so as not to disturb the potentially beneficial results of some mergers.

In my opinion, legislation which I and others have introduced in the Senate, S. 420 and S. 476, which are similar bills and involve the kinds of approaches that I have talked about, and which Congressman Jones has introduced in the House, takes such an approach by,

One, disallowing the deductibility of interest on junk bond financing of hostile two-tier takeover attempts; and

Two, we have limited it to the multitier approach and have imposed an excise tax on greenmail profits. Here we impose a 50 percent tax under these 2 bills on profits from appreciation of stock values, very rapid appreciation on stock held by a group for less than 2 years. They are not long-range investors in the company; they are short-term players who have gotten in in order to leverage a greenmail payment.

That applies to those who have acquired a 4-percent-or-greater share of the stock and who are themselves engaged in making this kind of takeover attempt.

By addressing the problem of stepping up the basis on assets of the acquired company: If you use junk bond financing to get a company, then you sell off its assets, you cannot avoid paying tax on the difference between the earlier value of these assets and what you are able to sell them for.

Thank you for drawing attention to a very serious national problem by holding this series of hearings. I appreciate very much the opportunity to participate in them.

[The prepared statement follows:]

STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Mr. Chairman, while much has been said about the ill effects of corporate mergers, it would be wrong to suggest that all mergers are bad. Many voluntary mergers have combined research resources and marketing capabilities to enhance the ability of the new unit to compete in the world markets. With the ever increasing interdependence among U.S. and the world economies, we can no longer afford to take just a domestic view. We must recognize the importance of our ability to compete abroad and we must not underestimate the contribution to that effort that voluntary mergers can make under appropriate circumstances.

It is also true, that not all hostile mergers are bad. Sometimes an ineffective management team needs to be replaced. Where the management has not done enough to maximize stock performance and a more efficient use of corporate resources is available, hostile corporate takeovers may help accomplish these tasks to the benefit of the stockholders and the economy at large.

Therefore, while there are problems with corporate mergers that need our attention, we must be careful in crafting a remedy to target the abuses while not preventing the legitimate economic activity, to which I have referred. We must interfere with the free market as little as is possible.

While I acknowledge that mergers can in some instances be helpful, the economic justification for two-tier hostile takeovers is more difficult to establish since the same offer is not extended to all stockholders. It is hard to see how all stockholders could be said to benefit when a few stockholders receive higher prices for their stock than the average stockholder. It is also hard to see how it could be said that all stockholders are benefited when a small group of stockholders, by threatening a takeover, receive what is commonly "greenmail" payments for the stock they may end up holding for only a very short time. These are payments which other rank and file stockholders do not receive. It is difficult to understand how it is in the long range best interest of the country for this to happen, particularly when one considers that such payments use cash that could better be used for research and development, modernization of plant, or other investment purposes which are critical to remaining competitive. Instead, the cash is diverted to speculators who have no interest in the long range productivity of the company.

Business investment priorities are further distorted by merger activity. Not only are the alternative uses of cash skewed, but so is the ability to borrow. While a target company may want to borrow for expansion, its creditors will limit how much they loan based on the perceived ability to repay from anticipated cash flow. On the other hand, those who attempt to takeover that very same corporation may be able to get their creditors to stretch the value of the target balance sheet much further since liquidation value rather than anticipated cash flow is the critical factor. This is clearly a bad situation.

Use of so-called "junk" bond financing where the loan is secured only by the anticipated value of the assets of the target company, is also very questionable in situations where used in a two-tier hostile takeover attempt or where used to leverage a "greenmail" threat. In the recent stock play by Carl Icahn against Phillips Petroleum Company, it was clearly contrary to the national interest, the interest of the company, its stockholders, and employees, for the greenmail payment to have been brought about by the leverage power of junk bonds. Even if Icahn had used the junk bond route to prevail in the takeover, it would still not serve the national interest because the company would, of necessity, have been dismantled to retire the debt. The cannibalization would occur without concern for the well-being of the community, the employees and their families, the retirees, or the long run impact on domestic energy production.

It is particularly inappropriate that the tax code is not even neutral in these situations but rather it appears to encourage greenmail and takeovers by junk bond financing by (1) allowing the deductibility of the interest expense, (2) stepping up the basis of assets acquired, and (3) allowing the potential for lower tax rates on appreciated stock by giving it capital gains treatment.

The current climate affects not only those associated with companies already taken over and those not at play, but also all companies who may anticipate attack. Uncertainty on their part has been the impetus for defensive actions which are designed either to make the company unattractive to a possible pursuer by overburdening the healthy company or to make short term profit a priority over long term productivity so as to get the price of the stock up too high to continue to be attractive as a possible takeover target. Neither reaction bodes well for the future economic health of our country.

In summary, while we want to stop the abuses and ill effects of two-tier hostile corporate takeovers, we must be careful to take a rifle shot approach so as not to disturb the potentially beneficial results of some mergers. In my opinion, legislation which I and others have introduced in the Senate (S. 420 and S. 476), and which Congressman Jones has introduced in the House, takes such an approach by (1) disallowing the deductibility of interest on junk bond financing of hostile two-tier takeover attempts; (2) imposing an excise tax on greenmail profits; and (3) addressing the problem I alluded to earlier in my testimony about stepping up the basis on assets of the acquired company.

Again, thank you for drawing attention to a serious national problem by holding these series of hearings and for allowing me to participate.

Chairman PICKLE. We thank you, Senator. We appreciate your testimony and the fact that you are here this early on Monday morning.

Congressman Jones, our colleague, would have also been here to testify but I understand he is an observer in the San Salvador election. If he comes back in good shape tomorrow, we will hear from him at that time.

We have Senator Proxmire and Senator Chafee, who will testify and who will be coming in at different times.

We may have an interruption upon their arrival but anticipate hearing from our Joint Tax Committee representatives in the meantime.

We will start the questioning. I want to ask each member to try to limit your questioning within the 5-minute period, because we have several witnesses for today.

Senator, could you tell me just in round figures, if possible, how much money did Phillips Petroleum borrow to fight the takeover attempts? How much money was actually involved in those events?

Senator BOREN. I think, Mr. Chairman, it is around $4 billion, and there is an estimation that the company may be forced itself, in order to service this debt, to shrink the size of that company by as much as 20 to 25 percent, the current value of that company, in order to fight the takeover attempts. So they have had to go heavy into debt in order to fight these two takeover attempts.

Chairman PICKLE. Now that Phillips has been saved, will Phillips be paying less Federal income tax than before?

Senator BOREN. I think there is no doubt about that, because they are going to have this heavy debt service that they are going to have to undertake now.

Chairman PICKLE. Did you mention the size of the debt service that they have at this point?

Senator BOREN. It is going to be around $4 billion of additional debt service so you can figure applying the interest rate to that that will be deducted from their corporate tax liability, the payments on that debt will undoubtedly reduce the amount of taxes they can pay.

It will also reduce employment. We have approximately 10,000 employees of that company within the boundaries of the United States. There is not a doubt in my mind that the number of employees will eventually be cut back somewhat, the income tax that they will be paying will be cut back.

They have also indicated that they will have to reduce their exploration budget considerably. So this means fewer wells drilled. You have about 200 jobs associated with every drilling rig, so I think you can see that the ripple effect of the reduced ability of this company to operate is quite large.

Chairman PICKLE. The bill which Congressman Jones and you and others have introduced seems to concentrate on the question of greenmail and the deductibility of interest.

What is your primary concern about greenmail?

Senator BOREN. Well, sir, I think that we want to see the most appropriate use of resources made within our economy.

I know the argument that any money paid any place in the economy ultimately is going to eventually recycle itself and come back into some kind of productive enterprise, but when you look at where we are in terms of our national economy, in terms of international competitiveness, it is very important that we target the use of our dollars into areas that will most immediately improve our productivity.

And it is very hard to see—in this case you had a person when the first play on Phillips stock began, went out and borrowed a lot

of money because he thought the stock was going to go higher. As it turned out, the first takeover attempt ended a little earlier than he expected. He didn't sell his stock when the price was at the peak, so he was due to lose $8 or $10 on the stock.

Then he says, "Either pay me what I paid for the stock so I don't suffer a loss or I will start a leverage attempt to take you over, not by offering all the stockholders the same value of stock but by buying only a portion of the inflated stock"—not with money he had, but money that he was borrowing through a junk bond financing route with the bonds that the billions of dollars generated that he was going to use to make this takeover offer after only being secured by the assets ultimately of Phillips.

This is why we say we think that had he been successful—and he was successful in that he realized a gain on the stock which he hadn't owned very long—say he succeeded in taking over the company, suppose the company was already so weak, suppose this was the third or fourth effort like this; if he had achieved taking over the company, the only way that he would have been able to pay off the bonds on schedule would have been to sell off all the assets of the company.

So we are targeting on two things. We don't think it is right for people to come in and by threat be able to manipulate the value of stock, and that is what you are doing by getting a certain leverage within the company. You are saying to the management of the company: "Pay me so much for my stock to enable me to make a large profit." That is what we are referring to as greenmail.

Or, "I am going to proceed with this takeover attempt." We don't think that you should be able, through stock manipulation and leverage to deliberately obtain a leverage position, to make a large profit. And you are not even paying regular income tax on that. You are paying at the capital gains rate because you either hold the stock long enough to qualify or shift it to a corporate shell, to hold the stock for long enough to get it at the capital gains rate.

Chairman PICKLE. What is your definition of greenmail?

I notice you put a 50-percent excise on that. How do you arrive at the 50 percent and what is a friendly and what is a hostile merger?

Senator BOREN. A friendly merger is one that the company itself, the company management does not fight; they agree to it.

And a hostile takeover attempt is one—we are zeroing in on two-tier or multitier attempts, where someone offers not to buy all the stock.

Let's say a company is performing poorly, and the stockholders are not being served, bad management. Someone comes in and says, "We offer to buy the stock. We will pay all the stockholders a certain amount of money for their stock." We are not covering those situations.

But where someone says, "We only want to buy a portion of the stock," 30 or 40 percent of the stock, whatever the figure is, 50 percent, or just enough to get you a leveraged position. "We are going to pay for that stock a price far above the present market value of the stock," you are offering that just to enough stockholders that you begin to get a leverage position in that company, not to all stockholders, and then you use that position to get a payment

for your own stock that you have acquired by this method, whether it be 10 percent of the stock or however much you have gotten to get a highly inflated price.

The Phillips stock, say the stock was at 45; Mr. Icahn, I believe, ended up getting in the fifties, the equivalent of $55 a share for his stock. So he sells stock for a very short period of time. He got $10 more for his stock than was the prevailing market price when he started the activity. He won't pay income tax at the normal rate, or that $10 gained.

We will hold it long enough to get capital gains treatment on it. We are saying, in addition to the tax rate, we impose a 50-percent direct excise tax on that excess profit that he makes on what we are here defining as greenmail, rapid appreciation value of the stock, which he himself caused by his own manipulation.

What we are trying to do is put enough of a tax on it, in addition to the regular income tax or capital gains that he would pay, to more or less tax away the profit from that.

When you take away the incentive through the tax route, I think people are going to no longer try to make these greenmail profits. If they don't get to keep it, they will be a lot less interested in undertaking this kind of activity.

Chairman PICKLE. How do you arrive at an excise tax of 50 percent? Is it just a sort of *x* factor?

Senator BOREN. Mr. Chairman, I would say that that is not a figure that we have to live or die with, but if you put that 50 percent on top of the maximum income tax rate, you are getting fairly close to taxing that away.

I think if we can come as close as we can, and I would say that is something the committee should look at, as close as we can come to 100 percent taking away any potential gain, I think we need to put a large enough excise tax on top of the income tax they pay, that the greenmailer doesn't have a financial incentive to do it.

Chairman PICKLE. If we go the excise tax route, wouldn't the raiders, in anticipation of the tax, simply increase their demand to cover the anticipated tax?

I think we need to discuss further the definition of what is a hostile takeover to determine how we go from there.

My time is expired. I turn to Chairman Rangel.

Chairman RANGEL. Thank you for bringing your unique personal knowledge to these type of problems that you have in your home State to this committee.

We don't want to throw the baby out with the bathwater. We want to take it in when there is an abuse.

Following that line of thought, in your hypothetical the raiding company came in and borrowed the money at tremendous interest rates, targeted a certain percentage of the stock, and in taking over, you indicated that the disruption to jobs and research to the community would be based on that the way the company could possibly repay money borrowed is through the liquidation of the victim company.

My question, is it possible under that hypothetical, or Macy's taking a look at Gimbel's, that they truly believe that they have better managerial skills. They can do a better job, broaden sales, diversify in terms of location, they feel the only way they could

take over is to make a two-tier pitch to really get at the number of stockholders that they need to be successful. They target and do have a higher price in that they truly believe that the merger would create jobs? How do we handle that?

Senator BOREN. I would say, Mr. Rangel, that I think there are circumstances where that could be correct, although I think it is more likely that if you had a company with the sufficient resources to move that they would make the same offer to all stockholders. That is No. 1.

No. 2, I think there was an indication, for example, in the second case, the Phillips attempt, the second attempt, that there was really no interest in taking over the company or managing it. That was argued in the first case.

Pickens said he wanted to take over the company and manage the company. I don't think that was even said or alleged in the second case. This was just blatantly an effort to get the value of the stock up because somebody had borrowed money to buy the stock when it was higher and the market went down after he bought it.

You are trying to protect your pocketbook interest and the amount of money you have invested in stock at the wrong time.

Chairman RANGEL. It is clear in your hypothetical——

Senator BOREN. I would say this, that we would not prohibit—this is the reason I think it is a little better to use the tax approach if we can craft it, be it excise or income tax. Maybe that ought to be looked at as to which would be more effective.

Take your Macy's and Gimbel's hypothetical. They do form one single company, and it is more effective. In that situation, where they have ended up taking over the management of the company and succeeded, I don't believe, under our definition, it certainly could be crafted so that it didn't, that you would have a greenmail payment or something that would qualify for the greenmail tax.

If you are actually managing the company, greenmail is something that is paid when the attempted takeover is not successful. So if you attempt to take it over and you are not successful or you are really not serious about taking it over, you would only pay the tax. Certainly it could be crafted in that way under those circumstances.

If the two companies actually merged and were managed as a unit, you could structure it in a way that would ultimately not pay the greenmail under that. If the aim was to threaten in order to make a profit by manipulating the market, they ought not get a profit.

Our aim was not to cover the kind of situation you are talking about. Our aim was covering manipulation, getting a big profit out of it, and they have nothing further ever to do with that company ever again. They go off.

The two tier, I do think that it is something we ought to consider as to whether or not it is really in the benefit of public policy. If we are interested in helping stockholders to allow multitier offers, where you are treating some stockholders differently than others, offering different prices to different stockholders, whether or not that is good policy and whether or not we should allow financing purely based.

And I thought Art Buchwald had a great column. He said:

> No longer is it the dream of anyone to hit oil in their back yard. The price of oil is going down. You would be better off, you don't even need money to do it or resources, borrow several billion dollars based upon the value of the assets of the company you want to take over, get into a stock play, and that ought to be the dream of everybody now.

That is what we are aiming at. Not all hostile takeovers, not situations where you have someone come in and take over the management of the company and make it a more effective unit, but a situation where all stockholders are not treated the same, where you are using bonds secured only by the assets of the company.

They took over Phillips. You are not going to get the cash flow by managing the company sufficient to pay off the amount of money you borrowed under the time constraints you would have to sell off the company and sell off the assets in order to pay it off.

So if we target the abuses, I think that is what we have to do. It wouldn't apply to your hypothetical.

Chairman RANGEL. Thank you.

I have a question on net operating loss, but I will see how the panel goes and maybe the second time around.

Chairman PICKLE. I hope you can come back to that, Mr. Rangel.

The Chair recognizes Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Thank you, Senator.

Are you concerned only about energy companies? In your testimony, you focus on energy corporations.

Senator BOREN. Yes, sir; I would say I focused on that because that got the attention of us in Oklahoma.

You have a company with 8,000 employees in a town of 35,000, the largest corporate citizen in our State, and the impact that that had on that community, on everything in the State from scholarships to everything else, the life that that corporate citizen, the role they played in the life of the State.

It brought home to a lot of us—I have been a free market advocate. A year or two ago when the moratorium on oil company mergers was proposed, I was skeptical. Then going through the experience of clearly seeing the market has been abused and how resources that have been misdirected as a result of manipulation, it has caused me to totally rethink my attitude.

I think it is not only a problem in oil. Perhaps they are unique targets because the value of oil in the ground is often higher than the value of stock in the industry. Because of other things going on in the industry, they have become an attractive takeover target. But I think it is in other companies.

Mr. SCHULZE. The market doesn't function properly according to our standards all the times, but in most instances where we try to play God, we are just as wrong as the marketplace.

Senator BOREN. Well, I would say that I don't think we can operate under the assumption that the market is always going to yield the right result. There are other things that can come in and affect the market.

Mr. SCHULZE. Can we operate on the assumption that what we do is always right?

Senator BOREN. No; whatever we should do, we should have as a goal that we interfere with the market as little as possible and still accomplish the objective.

Mr. SCHULZE. In how many mergers or acquisitions is greenmail a factor?

Senator BOREN. I couldn't give you a percentage as to how many; it has been a factor. We have seen it in oil industry attempts lately, in some of the most publicized attempts.

Mr. SCHULZE. We have seen a few fairly well publicized examples, but I would imagine that greenmail is used in very small minority of all mergers and acquisitions, wouldn't you?

Senator BOREN. I would certainly say it is a minority, yes.

Mr. SCHULZE. I have no problem with doing something about greenmail. It is an abuse.

But in most corporate mergers or takeovers, isn't a partial buyout of the stock or an offer until they leveraged or a majority position a normal type of activity rather than a total purchase of every share of the stock?

Senator BOREN. I would imagine that there are more mergers—of course, there are also many more friendly mergers than hostile mergers when you get into percentages.

We are talking about a minority of the minority when we are talking about two-tier hostile and greenmail situations.

I would say that a majority of the mergers in the country, which are probably friendly, that there is in essence one offer for all stock and there is acquisition through this method rather than differentiating between stockholders.

Mr. SCHULZE. That often ends up with issuance of different stock or stock in the acquiring company.

Senator BOREN. That is correct. Rather than a cash payment, they become stockholders in the new merged unit.

Mr. SCHULZE. Do you have any figures on what a 50-percent excise tax would bring in?

Senator BOREN. I don't think so.

Mr. SCHULZE. I presume such a tax would not be considered a revenue enhancement measure——

Senator BOREN. Not a huge amount. But one of the things we have to concern ourselves about, and I think we all want to encourage real economic activity in our country and investment that will increase productivity, that is the kind of thing that can grow if we allow this market abuse to continue.

The more people reading the Buchwald columns and say, rather than go to the work to try to find oil and do research and development, I put my time and talent, it is a tremendous waste of intellectual talent. So I think we have to worry that it is a relatively small percentage now, but it could grow in terms of revenue lost.

Mr. SCHULZE. Greenmail also could be viewed as an inefficient management tool to buy off someone else attempting to come in and take over, too?

Senator BOREN. That is correct. I don't think that that happened—I happen to think that the management of Phillips is by and large good management.

There is nothing in existing law to prevent bad management from misusing the assets of the company and creating too much

debt for the company in order to prevent maybe good managers from taking over.

Mr. SCHULZE. I would like to go into the definition of hostile. How did you arrive at your definition of hostile, and why you think that is a good method or yardstick to use.

Senator BOREN. Let me cite the definition. It means any offer to purchase or otherwise acquire the stock of a corporation. If such offer is disapproved by a majority consisting of at least two members of the continuing independent members, not inside directors but outside directors of the board of directors of such corporation, any member of the board of directors shall be treated as independent if such member is not an officer or employee of the corporation.

Now, that is just a starting point and I would say again that is a very difficult area. We don't view that as engraved on stone as to whether or not that is the appropriate definition, but that would be the starting point.

That is the way we define it in the bill.

Mr. SCHULZE. You say you don't feel that strongly about it?

Senator BOREN. I don't think that is engraved in stone.

What we were trying to say is that of course many directors are employees and officers of the corporation in many cases. We were trying to aim it at those who are more independent members of the board, the so-called outside directors.

Again, trying to get around what you are talking about, that if you have bad management, I am no more interested in protecting bad management from operation in the marketplace than you are. And whatever remedy we have, let's be careful we don't do that.

Mr. SCHULZE. Perhaps we could bring in a specialist from Wall Street on this area and let them be gods.

Senator BOREN. I don't think it is a matter of making anyone gods. Our whole securities law——

Mr. SCHULZE. You are getting pretty close to it when you are saying they can or cannot.

Senator BOREN. I don't think so, because we have securities laws to prevent securities fraud and market manipulation.

For those of us who believe in the free marketplace, as I do, I think we have to be very sure that we preserve the free marketplace, preserve the soundness and honesty, keep it free from fraud, so there is confidence in it and it can operate.

I think careful interventions are in the long-range interest of preserving the market.

Mr. SCHULZE. Then I think we should do it through laws in that area and not through the Tax Code. But I thank you.

Chairman PICKLE. The committee has asked Treasury to give us an estimate of the number of greenmail instances that have been prevalent here in the last year, and the consequences of them.

We have also asked them to give us some kind of a definition of what they think is a hostile or friendly takeover.

The Council on Economic Advisors has said 69-plus percent of takeovers are friendly takeovers and about 30 percent are hostile. If that committee's definition or measuring stick isn't proper, we can say about 70–30, although it is just a guess.

In your case, in the legislation you are recommending, you are saying that a hostile definition is determined by a vote of the target corporation's directors?

Senator BOREN. Most particularly the vote of the outside directors, the independent directors.

Chairman PICKLE. That raises a policy question, Mr. Schulze says.

Senator BOREN. Yes.

Chairman PICKLE. Is it proper for tax treatment to be decided by the directors inside or out, or preferably on the outside?

I don't know of any other place in the Internal Revenue Code where this is allowed. That is not to say that we ought not to have some kind of definition or approach such as this, but it does create problems.

I agree with you when you say that perhaps some of this ought to be left to the States. I understand now that there are many companies throughout this country that are in the process of adopting in their bylaws antigreenmail charter amendments. They are just simply saying you can't have a greenmail; you can't pay for it like that.

Senator BOREN. Mr. Chairman, there have been many questions raised about that. Let me say again, as a former Governor, in addition to someone who believes basically in the free market, I also believe in State and local rights to look into these matters.

But there is a problem. There is a question in the courts as to whether or not these sorts of provisions are allowed to prevail. There is a dispute between Federal and State courts as to jurisdiction, and which State courts have jurisdiction.

There is a real question as to whether or not this is not an area that has to be addressed on a national level because of its involvement with the national economy. You get into the question of whether or not this is a field, of necessity, occupied by implication and by Congress and what power State governments have to even deal in this area.

So I think that the question of what we let the States do may be somewhat moot because of the commerce clauses being interpreted in a way that would not let the States deal adquately with the problem.

Chairman PICKLE. Thank you.

Congressman Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

I appreciate your testimony, Senator, and your approach, trying to be very specific in offering at least an attempted solution to this problem.

You have mentioned that you would put a 50-percent excise tax on those who receive greenmail. What about putting a 50-percent excise tax or applying the same principle to those who pay greenmail? Have you thought about that?

Senator BOREN. I think it is not a bad idea to discourage it at both ends. I think that should be considered.

However, one of the problems is that, given the existing circumstances, I think you want to take all the profit motive out of it that you can to this kind of abuse of market. Sometimes a perfectly

good company, what kind of defenses do we allow to a company in this circumstance?

I think you can understand why we in Oklahoma, particularly in the second Phillips takeover, where there was no possibility that the people were interested in managing the company—they were going to dismantle the State's largest corporate citizen with all the impacts on employment, they are usually the first people to match scholarship funds, anything else you name. So the devastating impact, what can you do? How can a legitimate company protect itself?

Mr. FLIPPO. I think those are important questions.

I guess I should say at the outset that I am not talking about the specific situation that exists in your great State, but I am really talking about I guess is theoretical, because it goes to the heart of whose interest is really protected by greenmail. There are those in other committees in the Congress that are looking at—to the SEC, for instance—for relief in this area.

I know that some are raising the question of a violation of a trust in order to pay greenmail because they are offering payment to a specific group of stockholders and using the assets of the corporation.

Did you look at the SEC approach as opposed to the excise tax approach?

Senator BOREN. Somewhat; there did not seem to be much interest at the present time by the SEC itself in using any powers they now have.

The indication was they didn't feel they had any present way in which they could step into the situation. They seemed very reluctant to step in.

In the cases that I have seen, they have not stepped in to date. Whether or not we could give them additional directives and additional powers, that might be a possibility.

It goes back—I understand what was said a minute ago about whether or not it is appropriate or inappropriate to use the Tax Code as opposed to a regulatory approach looking at fiduciary responsibility. We started with the value of trying to interfere with the marketplace as little as possible.

We felt that perhaps by changing the nature of economic incentive or disincentive, we might be able to do it through the marketplace without having to have so much regulatory intervention. But I think it is worth exploring the other possibility as well.

Mr. FLIPPO. I thank the chairman.

I thank the gentleman for his responses.

Senator BOREN. It is patterned after the golden parachute sections of last year's bill too, when a similar approach was used.

Chairman PICKLE. Let me invite Senator Proxmire to come to the table.

Mr. Thomas.

Mr. THOMAS. I thank the Senator for bringing his legislation before us. It certainly is a matter that the Congress has to look at.

This member still is not sure whether it is a chipmunk or a skunk.

I appreciate the concern that the Senator from Oklahoma has as well.

The mergers tend to go in waves, and it looks like we are on the upswing again. So the numbers we might anticipate increasing.

Based on some of the statements that the Senator has made, I would like reactions to counter statements.

Would you agree that market price up or down is not necessarily at any time narrowly tied to the real value of the corporation? Are there not many other factors that influence the price?

Senator BOREN. That is certainly often true.

Mr. THOMAS. And that at times the price that you indicated as an inflated price might be a more realistic price for the corporation than the market price?

Senator BOREN. I think that is true.

In this case, we have used the example of oil stocks. A number of them for various reasons are undervalued right now.

Mr. THOMAS. You use the oil area, and it is incumbent upon this member to mention that I am concerned about the energy area as well, because my 20th Congressional District in California produces more oil than the entire State of Oklahoma.

Isn't it true that Government policies influence the energy area, including whether it is old or new oil, old or new gas, the depth at which it was acquired, the fact that it is cheaper to acquire resources of another company than get your own? Do you agree all of these affect the price of stock in the dynamics of what is occurring?

Senator BOREN. I agree.

Mr. THOMAS. The Government is not deciding to step in; they are already in the middle of it.

Senator BOREN. I think Government has contributed to the problem.

Mr. THOMAS. Focus on hostile or friendly takeovers. You want just the good ones. You have indicated that one of the criteria might be whether or not there is, in fact, a better creature that emerges from the takeover, either better management or more profits.

What scares me a little bit here is you, in effect, are saying that courtships don't count, only marriages; that if somebody had good intentions, but they didn't follow through, that means they didn't because they didn't produce a merger, and it wasn't better managed either.

The last thing I think we want is to create a tax policy in government structure where people decide on a merger for tax purposes rather than because it makes good economic sense. We are trying to clean up the Tax Code to remove those factors as well.

Senator BOREN. We have to be careful we don't do that. That is the reason we get into not only greenmail tax, but also into the question of tax on the interest on the borrowed money. We also get into the question of if you are buying to liquidate rather than to manage it, that there would be a taxable event there on the value of the assets.

Mr. THOMAS. I am reluctant to characterize it. I don't know if it is attitude or the results that make it hostile or friendly. Your definition gives us something to go on, but I don't understand the need to distinguish between hostile or friendly.

My problem is, and this is why I have difficulty with the way that you approached the solution, that I really don't think I care whether it is hostile or friendly.

We should be less concerned about what happens in the dynamics. Rather we should think of it in terms of a sales contract and whether or not pressure to sign a contract should define a hostile situation. If so, a waiting period would be triggered followed by information and time, which would allow the stockholders to make decisions in a more rational way. It might not ought to be the Tax Code as well.

Senator BOREN. There may be other ways of approaching it. You and I are really approaching it from the same starting point. No. 1, we don't think all Americans are bad. No. 2, we are very concerned about inserting our own judgments for that in the marketplace, which ones are good and bad. I started down this same process and tried to narrow the remedy and make it as narrow as possible.

It seemed to me that if you allowed for some tribunal, the last thing we would want to do is say, all right, the SEC is hereby allowed to prevent good mergers and prevent bad mergers.

You get into playing of God, broadbrush interference. You have to somehow draw the lines, the assumption being it is an imperfect thing.

We tried to target as few as possible. There could be friendly takeovers where they are not productive. You get two sets of stockholders, boards of directors, at least it is their best judgment that it is in their best interests or it wouldn't be friendly.

One group of investors with sufficient resources, keeping the company and managing; two, that strongly enough believe they are right to make an offer on one group of stockholders.

I guess we would step back and say, we ought to step back and say, we ought to let that happen, even if we might be sympathetic to the existing management of a company. Where they are just taking over a small portion relatively of the stock, only willing to make the offer to some stockholders, where they perhaps don't have the capacity to keep the management, not borrowing the money based on assets they already hold, but only on those they intend to acquire, not getting too much risk themselves, you see what I mean, that is perhaps an easier way to narrow it down than the regulatory approach.

Mr. THOMAS. Senator, my time has expired, but even your example of asking the SEC to make decisions which are substantive in nature is a position that I cannot take. We can create procedures that need to be triggered by definitions of hostility.

Senator BOREN. Length of time, all these things happen.

Mr. THOMAS. I thank the chairman very much.

Chairman PICKLE. Thank you. Mr. Anthony.

Mr. ANTHONY. I have one question.

You indicated three basic things that you were concerned about. A group of investors which have been termed raiders, by threat manipulate to devalue the stock for a very few, and thereby to exact greenmail from the target corporation.

Nothing is said about management. I would like to ask if you have taken a look at T. Boone Pickens' track record, and if you can tell me what type of manager he has been.

For instance, in Supron, Citiservice, General American Oil, Superior Oil, Gulf, and Phillips, what kind of track record does Mr. Pickens have after he has taken these companies over and started running them?

Senator BOREN. The ones that you have named have not been taken over and managed by him.

Mr. ANTHONY. He has publicly said that he would like to take over this company, because the stock is undervalued and management is bad. You are saying he has not taken over and managed any of them?

Senator BOREN. That is correct.

Mr. ANTHONY. That is a very important fact, not only for Mr. Pickens, but for all other raiders. That needs to be taken into account because he is fond of going around the country saying, my letters read "Dear Mr. Pickens," he has driven up the stock for some stockholders, and therefore, he has also benefited.

Senator BOREN. A minority of stockholders are benefited in these cases because that was not an offer to all stockholders.

Enough did get in on it, so more than one person benefited. My putting an excess profits tax, if we want to call it that, on greenmail payments, you give a really strong incentive to the person who says they want to take over the company, their real aim is to take it over and manage it and make it more efficient.

You give them a strong incentive to do that, because they no longer have this incentive to take their greenmail money and go home, and they are much less likely to take over the company unless they have the resources, and I don't think we ever want the market to foreclose the possibility of someone who really wants, and wants to put his own money at risk, borrow money against his own assets, believes in it that strongly, and to really get out and put it in play, and treat all the stockholders alike, give him an incentive to go ahead and do that.

Don't give them an incentive to quit early and make a profit from the stock play, and never have any beneficial results.

Here we are in competition with international trade. We are being—our level of investment is about half the level of investment in the competing countries. Our capital is one of the most precious resources this country has, if we are going to succeed in worldwide competition, and also our talent.

I happen to think people like Mr. Pickens and Mr. Icahn, setting aside others, these are people with immense intellectual talent, and a lot of resources also being used in these attempts.

If that talent and those scarce capital resources could be applied to increasing the resources in this country to compete with other nations, wouldn't it be in the national interest of this country to do it?

Mr. ANTHONY. I think the answer is yes. In your definition of hostile, you mention two out of three members, independent members, that is, those that are not officers or inside the company itself. My experience has been that management hand-picks their independent board members, and that these independent board members are really not as independent as the law says they should be. They are also not as independent as their fiduciary responsibility would be defined if they really look at the law.

Senator BOREN. You raise an interesting question. In the Phillips case, by the way, these people were truly independent because from some unique circumstances, that board, the outside directors several years ago, were appointed by the courts under a very unique circumstances.

There we were dealing with independent outside directors not hand-picked by the management who were resisting the situation.

Mr. ANTHONY. I yield back my time.

Chairman PICKLE. Mr. McGrath, do you have any questions?

Mr. MCGRATH. I will yield back my time at this point.

Chairman PICKLE. Mr. Dorgan.

Mr. DORGAN. Of all the amorphous terms I have heard in Washington, DC, I imagine free market ranks at the top. I don't know who could define it. There has been some talk about those who might tinker with it playing God.

In my judgment, we have an absolute obligation to attempt to define the free market. Adam Smith wrote about it, the cloak of the invisible hand, and so on, he and others since have understood that we have an obligation to create a free market, and one that works, and in the creation of that market, we need to develop some rules.

Senator Boren, in 1981, we had come to a committee that I served on, a fellow, the chief antitrust officer in this administration, Mr. Baxter, and I read to him a quote I had found from him, in which he said that if America had only 100 corporations doing all of its business, and each had 1 percent of the business that would represent perfect competition, and would be perfectly acceptable to him as the chief antitrust enforcement officer.

And I said, I really can't believe that you said that. You probably were misquoted, but I was curious, and he said, "I said it." I asked him how much we paid him as a public official to believe that sort of thing.

He told me in excess how much that was of his value. I wonder if you perceive the same kind of threat with that kind of thinking.

I think mergers, and acquisitions, the rate of growth, the drain from productivity, creative capability in this economy, possess something of a real threat to this economy, and are something we need to do something about.

I don't know the precise answer. You are speaking today as an Oklahoman who responded to the Phillips situation, and I introduced legislation in 1981.

Do you see a more general problem that we need to address as members of the House and Senate?

Senator BOREN. Yes, sir, I do. There is a great value in the strength of our society, which is determined by a lot of factors, the more people that you have that are making these decisions, how to manage, if it is a small business, a farm unit, a business or whatever, the more people we have in our country—Thomas Jefferson spoke on this very same subject—the strength of the country is enhanced by the more people we have, and the more centers where people have to exercise that own creative and individual responsibility, and certainly a country is much better served that has 1 million people exercising this kind of responsibility for meeting a pay-

roll, running a business, this kind of creative approach, this kind of stake in the society.

And the same reason we think it is good to have more homeowners than fewer, the kind of stakes you can give them on exercising responsibility, all of that greatly increases the strength of the whole fabric of this country.

I am very concerned about the trend toward concentration that prevents us from having that kind of individual incentive and initiative.

I do not regard monopoly, for example, the concentration of that kind of power in very few hands, so all the rest of us are merely employees of those who have the right to make decisions.

That doesn't strengthen the country, it weakens it and so, therefore, I think there are other values that you have to put in the mix in striking this balance.

I agree with what you have said, and I think that the approach outlined by the person you questioned in earlier years is wrong.

Mr. DORGAN. I yield back the balance of my time, Mr. Chairman.

Chairman PICKLE. I understand you have introduced a measure in this general field. Would you want to expand on it now or reserve?

Mr. DORGAN. I will reserve.

Chairman PICKLE. I believe that constitutes the questions for Senator Boren.

Senator BOREN. I thank you and the members of the committee. While we don't claim to have all the answers, perhaps we have focused your attention and the expertise of the people that are here this morning is very great, and I hope you will join us in this effort to target a real solution to a real problem.

Chairman RANGEL. Senator, did you take into consideration in the Phillips case, whether or not the net operating losses of the target company could be taken advantage of by the so-called hostile raider?

Senator BOREN. We did not, but that is a question that certainly ought to be pursued, because again, that is another thing that could be driving up tax advantage, a very substantial one, and you put a company in a weakened position like this, you are encouraging a lost situation that might have tax consequences, and your question is a good one, and we did not really take that into full consideration.

Chairman PICKLE. Mr. Rangel, our committee has asked Treasury for an analysis of the various takeovers that occurred primarily in the last year, and to give us its analysis of why they took place, and what method was used in each situation. We are hoping we will get some of that information from them later on this morning.

Now, we are pleased to recognize the Senator from Wisconsin, one of the most renowned investigators and recognized experts on almost anything.

STATEMENT OF HON. WILLIAM PROXMIRE, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator PROXMIRE. Thank you, Mr. Chairman. That is the most generous introduction I have ever had.

Mr. Chairman, members of the subcommittee, the long-term effect of hostile corporate takeovers is becoming highly detrimental to our economy. A very top priority of the Congress should be to slow down the wave of hostile takeovers which have become a cancer on the American business system.

I am delighted to hear Senator Boren testify, and we should do this with a minimum of interference with our free system.

Corporate executives have argued for years that hostile takeovers loot corporate treasuries; undermine our ability to compete in world markets; force management to sacrifice long-term strategy and the development of new products and services for short-term gains; inhibit innovation; lead to the misuse of capital; cheat shareholders; and cause job losses and economic upheaval that disrupt the lives of communities and employers. I agree, and if you look at the facts, I am sure that you will also.

At a time when the United States has the largest domestic budget deficit in its history, $185 billion in 1984 and a projected fiscal year 1985 deficit of $222 billion, its highest international trade deficit ever, $123 billion in fiscal year 1984 and growing, and when we are facing increasingly aggressive competition from abroad to sell our American products and services in the world market, I believe our corporate managers should be concentrating more on building better and more efficient plants and products than spending time, money, and energy worrying about whether they are about to be raided and taken over by another hostile American company or group of corporate raiders. And this fear is real. In a recent survey of Fortune 500 companies, 67.2 percent of the respondents said that recent hostile takeover activity has caused their company to initiate or plant strategies in response to such an event.

Peter F. Drucker is certainly one of the most respected observers of business practices in the country today. He said recently:

> It is increasingly hard to defend the unfriendly takeover as benefiting anyone other than the raider, and a few investment bankers and merger lawyers. Anyone working with management people knows that fear of the raider paralyzes our executives.
>
> Worse, it forces them into making decisions they know to be stupid and to damage the enterprise in their charge. A good many experienced business leaders I know now hold takeover fear to be a main cause of the decline in America's competitive strength in the world economy, and a far more potent cause than the high dollar.
>
> It contributes to the obsession with the short-term and the slighting of tomorrow in research, product development, market development and marketing, and in quality and service; all to squeeze out a few more dollars in next quarter's "bottom line."

Concern over hostile takeover activity has been expressed by leaders from all sectors of American life, including Andrew C. Sigler, chairman and C.E.O. of Champion International Corp., and chairman of the Business Roundtable's Task Force on Corporate Responsibility; Paul H. Elicker, chairman and president of SCM and former spokesman on behalf of the National Association of Manufacturers; James Tobin, the Nobel Prize-winning Yale eco-

nomic professor; Edgar M. Bronfman, the chairman and CEO of Seagram Co. Ltd.; J. Peter Grace, chairman and CEO of W.R. Grace & Co.; John C. Whitehead, former cochairman of Goldman Sachs & Co.; Lee Iaccoca; Douglas Fraser; Felix Rohatyn; and many, many others, a number of which I am sure you will be hearing from.

By now, you are familiar with many of the problems associated with adversarial change of controls situations. But let me briefly summarize some of them.

Hostile takeovers and breakup liquidation takeovers are saddling corporate America with excessive debt. Last year alone, this country experienced a net loss of $90 billion in equity capital which was replaced with debt on corporate balance sheets.

All of this, I am told, was the result of debt incurred in takeovers, leveraged buyouts and stock repurchases.

John Shad, the Chairman of the Securities and Exchange Commission, and Federal Reserve Board Chairman Paul Volcker have each warned of the consequences of this leveraging of corporate America. I believe that if the current trend continues, this defunding of America will ultimately lead to economic suicide which we will experience during the next recession.

At the same time that I am concerned about the pyramid of debt we are accumulating in all sectors of our economy—domestic, international and corporate—I am increasingly concerned about the short-term orientation of American business management in an ever-increasingly competitive global environment. This short-term focus is enhanced by the pressures of a securities marketplace dominated by institutional investors and pension fund managers whose performance is measured on a quarterly basis and who demand virtually instant gratification in order to retain their portfolio accounts. Today, money managers control an estimated 60 percent of corporate stocks and bonds with more than $1 trillion in holdings. As a result, they have a big impact on the price of any company's stock through their massive purchases or sales.

Another aspect of the hostile takeover binge which bothers me is the almost instantaneous availability of funds to finance some of these deals when credit is not nearly so readily available for other economic purposes.

For example, it is difficult for me to comprehend how Carl Icahn can send Drexel Burnham Lambert out to raise $4 billion as part of an $8 billion proposal to take over Phillips Petroleum; or how the leveraged buyout firm of Kohlberg Kravis Roberts and Co., which came close to buying Gulf, could assemble $6 billion of bank loan commitments for a deal that would have had a debt-equity ratio of 30 to 1.

Still another example involves William Farley, hardly a household name, who raised $90 million through Drexel last year for his hard-fought takeover of Condec Corp., a Connecticut producer of high-tech components and military gear.

Says Farley: "When I started buying companies—in 1976, no one was really geared up to finance the stuff. Today, we could go out and raise probably $2 billion in 2 days."

I am amazed at the ease with which some people raise money for these types of activities, while for other simpler and more productive purposes, ordinary consumers cannot even get a loan. After

all, these deals in and of themselves create no new wealth; they simply reallocate existing wealth, moving it from the shareholders of the offerer to the shareholders of the target. No new plants are built, no jobs created, no wealth enhanced except that of the shareholders of the target and the attorneys and investment bankers for both sides. There are numerous other aspects of these changes of control situations which bother me. These I have expressed in my statement on the subject in the March 20, 1985 edition of the Congressional Record.

As I see it, there are three ways to realistically curb hostile takeovers.

First, amend the securities laws to make it difficult for corporate raiders to take over companies through hostile tender offers. I have introduced S. 706, the Corporate Productivity Act, in the Senate to do that.

A second approach is for the bank regulatory agencies to jawbone and discourage banks and other financial institutions from making loans or purchasing junk bonds to finance unfriendly takeover bids. I have written Federal Reserve Board Chairman Paul Volcker and Federal Home Loan Bank Board Chairman Gray, urging them to do so.

And a third approach is to amend the tax code to end the tax subsidies for hostile takeovers.

I am not an expert on the tax code; you are, so I will defer to the expertise of the committee when it examines the problem. Whatever the approach, we need to move forward aggressively on a variety of fronts to curb the corporate hostile takeover game. If Congress fails to act decisively, our economy will be further weakened by this activity. When other countries forge ahead in the race for capturing new markets, we will have no one to blame but ourselves. It is time we unleashed the American businessman to do what he does best, to develop better products and services rather than to worry about being taken over.

Thank you, Mr. Chairman.

Mr. Chairman, I would appreciate it if a copy of my speech could be filed in the record.

Chairman PICKLE. It certainly will be included, Senator. Thank you for this very good testimony.

[The speech follows:]

FLOOR SPEECH, SENATOR WILLIAM PROXMIRE, MARCH 20, 1985

Mr. President, today I am introducing the Corporate Productivity Act of 1985 to slow down the current wave of hostile takeovers and raids. The bill does not inhibit friendly mergers and acquisitions which are often critically important to our competitive strength.

At a time when the United States has the largest domestic budget deficit in its history, $185 billion in 1984 and a projected fiscal year 1985 deficit of $222 billion, its highest international trade deficit ever, $123 billion in fiscal year 1984 and growing, and when we are facing increasingly aggressive competition from abroad to sell our American products services in the world market, I believe our corporate managers should be concentrating more on building better and more efficient plants and products than spending time, money and energy worrying about whether they are about to be raided and taken over by another hostile American company or group of corporate raiders. And this fear is real. In a recent survey of Fortune 500 companies, 67,2 percent of the respondents said that recent takeover activity has caused their company to initiate or plan strategies in response to such an event.

By the end of this year it is likely that the United States will displace Brazil as the world's leading debtor country. Granted we have far greater resources to meet the problem, but meanwhile as the United States has been rolling relentlessly into the red zone in its international accounts, Japan has been moving just as dramatically in the other direction and is already the world's biggest creditor nation.

The point to be made is that everywhere you look these days the United States faces a flood or red ink and increasing competition from abroad. This red ink an debt has now hit our corporate boardrooms and can be attributed at least in part to the surge of hostile takeover and leveraged buyout activity.

A new term of are has been coined as a result of this binge of unfriendly activity we have been experiencing over the past couple of years. It is called the leveraging of corporate America. This corporate leverging must now be taken every bit as seriously as our domestic and international trade deficits.

Corporate executives have argued for years that hostile takeovers loot corporate treasuries; undermine our ability to compete in world markets; force managment to sacrifice long-term strategy and the development of new products and services for short-term gains; inhibit innovation; lead to the misuse of capital; cheat shareholders; and cause job losses and economic upheaval that disrupt the lives of communities and employers. I agree and as a result believe that such takeover activity should be tempered but not prohibited.

Peter F. Drucker is certainly one of the most respected observers of business practices in the country today. He said recently:

"It is increasingly hard to defend the unfriendly takeover as benefiting any one other than the raider (and a few investment bankers and merger lawyers). Any one working with management people knows that fear of the raider paralyzes our executives. Worse, it forces them into making decisions they know to be stupid and to damage the enterprise in their charge. A good many experienced business leaders I know now hold takeover fear to be a main cause of the decline in America's competitive strength in the world economy—and a far more potent cause than the high dollar. It contributes to the obsession with the short term and the slighting of tomorrow in research, product development, market development and marketing, and in quality and service—all to squeeze out a few more dollars in next quarter's 'bottom line' ".

Two and a half years ago, after his involvement in the Conoco-DuPont-Seagram-Mobil hostile takeover jousting, Edgar M. Bronfman, the Chairman and Chief Executive Officer of Seagram, voiced the concern of many leading businessmen in the United States when he said that "enough is enough". It should be pointed out that with respect to this particular deal Mr. Bronfman and his Seagram shareholders were delighted with the results. But afterwards he took a broader view and asked "But what of the general economy?"

It has been taken me some time to reach this conclusion but I, too, now believe that "enough is enough".

As I see it, there are three ways to realistically curb hostile takeovers. First, end the tax subsidies for such corporate mergers. This is the Bronfman approach and he explains it this way:

"If the interest on corporate takeover money borrowed specifically to buy the common stock of another corporation were not tax deductible, as it now is, such activity would be sharply curtailed. To the extent that it was not, Federal tax revenue would be increased and the average taxpayers would thus not be, as they are now, indirectly footing the bill for part of these corporate-takeover games.

"All activity in the field of mergers or acquisitions would not stop, of course. It would still be possible, even as it is today, to effect such marriages through exchange of securities, or sale and purchase of assets and other methods well known to industry.

"What would change is that unfriendly takeovers would become discouragingly expensive and bank credit would not be used to enrich a few shareholders, discharged executives, arbitragers, lawyers and others without real benefit to the economy as a whole.

"The tax-deductibility of interest on such loans is now, in effect, a Government-issued benefit and hence an intervention in a more desirable laissez-faire economic trend.

"So let's stop this tax benefit to corporations that encourages using credit to make money for a few. And let's try to get back to the successful, pre-eminent American enterprise system, instead of just moving huge sums of tax-deductible finite credit around."

A second approach is for the bank regulatory agencies to jawbone and discourage banks and other financial depository institutions from making loans to finance un-

friendly takeover bids. Such an approach would discourage the purchase of junk bonds by savings and loan associations and also the financing of unfriendly takeovers by banks who have been involved in the past after having curtailed some of their lending activity to the lesser developed countries.

And a third approach is to amend the Williams Act, the law which now governs tender offers. While I fully support the first two alternatives, the bill I am introducing today deals with the third. My bill is deliberately drafted so as to deal only with hostile takeovers. Its principal elements are as follows:

(1) any person owning more than 15 percent of a company's stock cannot purchase more except through a tender offer.

(2) The tender offer must be submitted to the target company's board of directors. If approved by a majortiy of the independent directors, the tender offer could be submitted to the company's shareholders under existing law and regulations.

(3) If the target company does not meet the standards for independent directors (as prescribed by the Securities and Exchange Commission) the tender offer can be submitted directly to the company's shareholders pursuant to existing regulations.

(4) If the tender offer is not approved by a majority of the target company's independent directors, the tender offer can still be submitted to the company's shareholders, but subject to the following additional requirements:

(a) The tender offer must be approved by a two-thirds vote of the target company's shareholders. Only shareholders of record as of the date of the offer are permitted to vote. The vote must occur within 60 business days from the date of the offer as determined by the directors of the target company;

(b) Prior to a vote of the shareholders, the shareholders must be provided with additional details about the plans of the bidder and the effect of the acquisition on the company and its employees and community;

(5) State law relating to tender offers is preserved and is not preempted except in those rare instances where compliance with the State law would make it impossible to also comply with the Federal law.

Under my bill what is and what is not a hostile takeover is left up to the determination of the independent members of a company's board of directors. For the provisions of my legislation to apply, a company must have a majority of independent directors, as defined by the Securities and Exchange Commission. (Some 68 percent of all listed companies on the New York Stock Exchange currently have a majority of such directors.) For those companies that do not, existing law would continue to apply.

In those instances where a majority of independent directors vote against a person's acquiring more than 15 percent of a target company's stock through a tender offer, additional procedural requirements would have to be met.

These include, most importantly, winning the approval of two-thirds of the shareholders of record on the date of presentation of the offer to the target.

Also, with respect to a hostile tender offer the time period for completing such a transaction would be extended to 60 business days. I believe that this time frame is important in many respects:

(1) It allows information to be developed and disseminated to average investors.

(2) It allows time for target boards to seek the best deal for target shareholders—by competitive bids.

(3) It gives all shareholders ample time to weigh their decisions and evaluate their alternatives.

(4) It sets up a framework for negotiation between the target and the offerer. Such a framework is helpful in maximizing the opportunity for the best deal for target shareholders and modifies the pressure for destructive tactics during the tender offer period.

Since I want to encourage longer-term investment in corporate America as opposed to excessive speculation, I provide that shareholders of record on the date of a takeover offer should be the ones who make the final determination whether a company should be sold.

The language of my bill is included at the end of my remarks. Now I would like to address some of the concerns I have already briefly referred to.

THE LEVERAGING OF CORPORATE AMERICA

This is a term we will be hearing more and more of in the future. Initially it applied to takeover transactions known as leveraged buyouts which resulted in public companies being turned into private companies mostly by borrowing against their own assets and shrinking their equity dramatically. Thus a public company with say $100 million of debt and $900 million of equity is turned into a private company

with $900 million of debt and $100 million of equity. Increasingly, however, the term is being used to describe the effects of unfriendly takeover and corporate raider activity upon target companies generally and the mountains of debt the target company is left with regardless of whether it is successful or unsuccessful in fighting off an unsolicited tender offer. This large accumulation of corporate debt resulting from the current takeover binge has reached such proportions as to cause considerable concern

For example, Paul Volcker, in his testimony on monetary policy before the Senate Banking Committee last month, on February 20, 1985 warned:

"Whatever the circumstances and justifications for the particular companies involved, a financial structure that tends toward more debt (and shorter debt) relative to equity becomes more vulnerable over time. More cash flow must be dedicated to debt servicing, exposure to short-run increases in interest rates is magnified, and cushions against adverse economic or financial developments are reduced."

Chairman Shad of the Securities and Exchange Commission has been even more direct in discussing the "leveraging of America". He described the situation in technical detail as follows:

"Corporate takeovers and buyouts are financed through large loans. The net effect is that debt is being used to retire equity, which is known as leveraging up a company's capitalization. The greater the leverage, the greater the risks to the company, its shareholders, creditors, officers, employees, suppliers, customers and others. . . . The more leveraged takeovers and buyouts today, the more bankruptcies tomorrow. During the past few years, the multi-billion dollar premiums shareholders have received in leveraged takeovers and buyouts have been a multiple of their losses from acquisition related bankruptcies. The premiums come first, the consequences later. The leveraging-up of American enterprise will magnify the adverse consequences of the next recession or significant rise in interest rates."

I agree. Last year this country experienced a net loss of $90 billion in equity capital which was replaced with debt on corporate balance sheets. All of this, I am told, was the result of debt incurred in takeovers, leveraged buyouts and stock repurchases.

Events over the past few weeks reinforce my concern over the debt accumulating in corporate America. According to newspaper accounts, the Phillips Petroleum pact reached with Carl Icahn Monday, March 4, 1985 will triple Phillips's debt to about $7.3 billion, making it by far the most highly leveraged major oil company in the U.S. Quoting from the newspapers:

"The plan offers a boon to some of Phillips' shareholders for now. But it also leaves the Bartlesville, Oklahoma company saddled with one of the biggest debt burdens in the industry, and thus it will be especially vulnerable to swings in interest rates and oil prices. Some said Phillips was bound to become less vigorous in oil exploration as a result. Jobs also are likely to be lost as the company carriers out a plan to dispose of assets."

According to Sanford Margoshes, an analyst with Shearson Lehman Brothers, Inc., Phillips' "primary concern will be getting out from underneath the mountain of debt."

Another recent example involved the battle for control of American Natural Resources Company (ANR) waged by Coastal Corporation.

Arthur R. Seder, ANR's chairman and chief executive officer, has said he was "outraged at the idea that someone from another part of the country who knows nothing about ANR or the people who work for it" would attempt "to bust up" American Natural Resources.

But more to the point at hand, according to Mr. Seder, Coastal would acquire so much additional debt in buying the company that it could not avoid "massive sell-offs of assets in order to service the debt," which would cause "a dismembering of our organization and further losses to the economy of Michigan and other states where we operate."

I obviously take no position in either of these cases and cannot verify the effect of the additional debt on Phillips or potentially American Natural Resources. But additional corporate debt there will most assuredly be and taking all such corporate debt resulting from unfriendly takeover situations into consideration, such debt will lead in time to an inevitable problem.

Another example where a corporate raider dumped heavy debt on a company involved Continental Group Inc, which was pushed into the friendlier arms of David H. Murdock and his partner Peter Kiewit Sons last fall by a Sir James Goldsmith raid. The sale chopped Continental's equity from $2.7 billion to $750 million and boosted debt by $2 billion.

Still another heavily leveraged company is Twentieth Century-Fox Film Corp., which Denver oil baron Marvin Davis bought and took private in 1981. Davis has pulled $539 million out of Fox to pay some of the debt he took on to buy it, and the company must raise an estimated $400 million to pay additional debt and keep making movies. "Davis has just raped this company," in the opinion of an executive of a rival film studio.

It used to be that long-term debt accounted for about 2.5 times short-term debt in a company's capitalization. Today that ratio is about 1 to 1 according to Shearson Lehman Brothers, Inc.

The long-term implications of such corporate decisions leading to excessive debt are often fostered by hostile takeover fears and have serious consequences. "If the trend continues," says the managing partner of a premier investment banking house, "it means economic suicide." Adds the chief executive of a natural resource company: "It's the defunding of America."

According to the investment banker, "the most dangerous possibility is that business will continue as usual until the economy takes a sharp turn for the worse, and some of the more highly leveraged companies that have emerged from takeover deals go under." Then he points out there will be the backlash. "There will be a hue and cry; questions of prudence, cries of where were the banks, the trustees, the pension funds, the regulators? What did all those lawyers and accountants and investment bankers do to earn those huge fees? You'll have Congressional hearings, the works. It will be a large and distinguished cast of characters."

I want to avoid this reaction and scenario and one of the many reasons I am introducing my bill to inhibit hostile takeovers is to slow down this over-leveraging of corporate America.

THE SHORT-TERM FOCUS OF BUSINESS

At the same time that I am concerned about the pyramid of debt we are accumulating in all sectors of our economy—domestic, international and corporate—I am increasingly concerned about the short-term orientation of American business management in an ever increasingly competitive global environment. This short-term focus is enhanced by the pressures of a securities marketplace dominated by institutional investors and pension fund managers whose performance is measured on a quarterly basis and who demand virtually instant gratification in order to retain their portfolio accounts. Today money managers control an estimated 60 percent of corporate stocks and bonds with more than $1 trillion in holdings. As a result, they have a big impact on the price of any company's stock through their massive purchases or sales.

According to Greg A. Smith, Executive Vice President of Prudential-Bache Securities, "the typical investment cycle was three to five years in the 1960s. Then money managers looked for good results over a year. That became a quarter. Now it's weekly and daily. It used to be we had an investment policy committee. Now there's no restraint on decision-making. It's more a casino operation."

It is no secret that the best defense against a corporate raid or hostile takeover is a high stock price, but it is also no secret that a company investing in a long-term strategy is also likely to suffer a short-term decrease in its stock price and thereby subject itself to an unwarranted raid.

Take the example of New York-based Grumman Corporation. Four years ago LTV tried to take over Grumman. LTV was unsuccessful and employees and retirees afterwards continued to buy shares in the company. Then, according to John Bierwirth, the chairman and chief executive officer of Grumman, when 51 percent of the company was held by people attached to the company, Grumman, with the consent of its shareholders, decided to make a long-term investment in its future. The company invested $40 million in the X–29 airplane knowing that, in the short term the investment would put earnings on a plateau. Within three trading days of making this announcement public to Wall Street the stock dropped 20 percent and, over a week, more than 25 percent. The airplane was subsequently developed, it has eight new technological innovations and that investment has turned out to be important and beneficial to the future of the company as well as to the national security of the country. According to John Bierwirth, however, that long-term investment would never have been made if the company had not been held 51 percent by its employees and retirees because of concern that the resulting temporary drop in stock price would have made the company the subject of a hostile takeover.

This story is reinforced by other accounts and commentary. Says Leon G. Cooperman, a partner at Goldman, Sachs & Company, "I don't think any company can afford a long-term investment today unless its managers own 51 percent of it."

Says Harold M. Williams, former chairman of the Securities and Exchange Commission:

"If you run a company in a way that penalizes short-term earnings, it weakens your stock, and you risk being taken over. . . . So the raiders enhance an already overpowering trend toward the short-term viewpoint."

One company that recently penalized short-term earnings and is now paying the price is ITT. Within minutes of ITT Corporation's announcement on July 11, 1984 that it was cutting its dividend by nearly two-thirds so it could afford heavy investments in the U.S. telecommunications business, money managers stampeded to dump their shares. By day's end, the price of the stock had dropped by roughly a third, in response to the cut and an announcement of lower earnings. In effect, institutional investors knocked the price down until ITT's new $1 dividend once more yielded the minimum 5 percent return that most institutions demand. And now the low price of ITT's stock makes it a potential takeover candidate, in the opinion of some Wall Streeters.

Seven months ago in its August 13, 1984 edition, Business Week ran a cover story entitled "Will Money Managers Wreck the Economy". The general conclusion was "yes" and on the cover Business Week had the following quote: "Their short time frame forces chief executives into an equally short time frame. There will be tremendous damage from it. It's scary." I commend this article to every one of my colleagues and agree with the general thrust of the story.

In the coming months I expect to be shown and hear about more economic studies that show that a shareholder of both a target and a bidder company benefit from hostile takeovers and raids and that these highly confrontational change of control situations are in fact good for the investor and the economy.

My own feeling is that these studies should be greeted with a high degree of skepticism and as anecdotal evidence insofar as they purport to show that this activity is of benefit to our international competitiveness and national security over the long term.

In fact their is increasing evidence to the contrary. According to Professor F.M. Scherer of Swarthmore College, his preliminary analysis reveals that "takeovers frequently lead to short-run profit-maximizing strategies, eventually leaving wasted corporate hulks in their wake." He also points out that:

"If takeovers are an important disciplinary mechanism stimulating managerial efficiency, one might expect the rapid increase in takeover activity during the late 1960s and late 1970s to have been followed by improved over-all economic performance—e.g., on such dimensions as productivity growth. In fact, the annual growth of outpout per work hour in the economy's private nonfarm business sector declined from 2.6 percent over 1947–64 to 1.7 percent over 1964–74 to 1.4 percent over 1974–84."

With respect to unfriendly takeovers forcing our corporate managers to think short term rather than long term, I tend to share the opinions that have been expressed publicly by representatives of the National Association of Manufacturers and the Business Roundtable. Representing the NAM, Paul H. Elicker, chairman and president of SCM, testified on May 23, 1984:

"While U.S. companies face an unprecedented challenge to successfully compete domestically and internationally, time, money, and energy are being diverted from managing businesses to devising and defending against hostile takeovers. Business decisions are being influenced by whether the effect of a decision will increase or decrease a company's vulnerability to takeovers. In brief, the threat of a takeover may tend to force management to look at short-term results rather than long-term results."

A few months later, on October 31, 1984 the same sentiments were echoed by representatives of the Business Roundtable who told the Securities and Exchange Commission that "Hostile takeovers threaten the well being of the country by causing corporations to react to intense pressures for short-term results." As Andrew C. Sigler, chairman and chief executive officer of Champion International Corporation and chairman of the Roundtable's Task Force on Corporate Responsibility put it, "These pressures can undermine the long-term strength of our economic system."

Sigler's views are noteworthy given his prior takeover experience where he and Champion stepped in as a "white knight" to save the St. Regis Corporation from a hostile takeover by Rupert Murdoch. Said Sigler afterwards of this particular situation in which he accomplished his purpose, "I have very strong feelings about a system that allows this sort of thing to happen: I think it stinks. If it weren't for Rupert Murdoch, St. Regis would never be part of Champion." "The whole game is nauseating."

RESEARCH AND DEVELOPMENT

To date there is not a great deal of specific evidence regarding how research and development is affected by hostile takeovers. But in its cover page story on takeovers March 11, 1985 Forbes had a section entitled "Mortgaging the Future". I want to quote from this article because it signals another danger resulting from this takeover activity. The Forbes story reports:

"When companies start worrying about sharks, practically the last thing they care about is tomorrow. As a result, one of the first items to go in corporate restructurings is the R&D budget. Long-range planning is pushed to the back burner when companies attempt to thwart current takeover attempts. . . . Aside from the scientists and engineers who are laid off, R&D dilution demoralizes everyone in a company because they suddenly realize that long-range thinking and planning have gone by the board. . . .

"Why would any company in its right mind do away with R&D in an increasing competitive environment? Says Norell (President of Provesta Corp., Phillips' biotechnology subsidiary), 'Everybody figures, hell, let's just get past today. Research is intangible, and there is little way we can prove that it benefits the company immediately. So we can save money by firing the scientists, and when this is all over we can just hire them back.'

"But it isn't that simple. Work in progress that is suddenly terminated is often superseded by more advanced research elsewhere. So what appears to be a short-term savings turns out to be not a long-term but an almost immediate loss."

ENTRENCHED MANAGEMENT

In defense of unfriendly takeovers the argument is made that these practices serve as a way for the free market to discipline managers who have been lax in their responsibilities.

Since I believe there may be some truth to this argument I do not propose to insulate incumbent management from such situations. Rather, I make them accountable in an unfriendly tender to a majority vote of their independent board of directors. It is my assumption that the independent directors wil be less inclined toward protecting such management than in serving the best interests of all of their company.

But while I recognize that there is a legitimate on-going need to keep management from becoming entrenched, at the same time I have found that generally it is not poorly run companies, but well run ones that find themselves targets—companies with large cash or security reserves, good cash flow, low debt-equity ratios and undervalued stock. A study of hostile takeovers in 1981 revealed the average target company had a 16 percent return on equity, well above the average for all companies.

Examples of companies that are known to have been well run but have nonetheless found themselves targets include McGraw-Hill, Mead, Scovill, and Martin-Marietta, to name a few.

I have also found that some of the most attractive companies for a takeover bid are those in which top management has already corrected past problems, so that earnings are improving, even though the stock market has not recognized this fact. Consequently, their price-earnings ratio is still low.

For example, at Carter Hawley Hale, pretax operating earnings were up 52.5 percent in 1983 from 1982.

Sharp takeover tacticians can recognize evidence of such progress faster than the market so that what we may have instead of a "discipline of management" is the threat of their being punished by the loss of their jobs for having been successful in turning their companies around.

Critics of management have also argued that they defend their companies simply to protect their jobs, painting a kind of selfserving, greedy chief executive.

Again, while this may be true in a number of instances, I do not necessarily believe it is an accurate commentary on the majority of the leadership of corporate America. According to Jay W. Lorsch, Professor of Human Relations at the Harvard Business School:

"It is clear that for most responsible top managers, their primary motives are for the long-term benefit of all the companies' constituents—shareholders, employees, customers and suppliers. The perpetrators of unfriendly takeovers and "greenmail" (the buying of large numbers of shares in the hope of forcing managers to buy them back at a premium) are the ones pursuing only personal financial gain and greed."

GREED

Who is and who is not pursuing only personal financial gain and greed is a matter of opinion considering the exorbitant salaries made by some of our chief executive officers today. But the fact remains that something worth looking into is going on in our system when it rewards corporate takeover artists with multi-million dollar profits or fees for simply participating and advising in the buying and selling of companies.

Take the raiders for instance: Carl Icahn will clear $50 million for his role in Phillips in addition to $25 million he will get in expenses. T. Boone Pickens will take home a profit of $89 million plus up to $25 million for his expenses in the same situation. The Bass Brothers made $60 million at the expense of Blue Bell; James Goldsmith $50 million at the expense of St. Regis; Charles Hurwitz $14 million at the expense of Castle Cook; Saul Steinberg $60 million at the expense of Walt Disney Productions; and the list goes on and on. In none of these instances did any of the individuals actually succeed in taking over and running one of these companies and, in most, they were bought out at a sizable premium compared to the market price available to all other shareholders. This latter practice is known as "greenmail" where corporate raiders are paid a premium by the companies to keep them from houding their company.

Then there are the fees paid to the investment bankers in some of these unfriendly deals: $10 million for 79 hours of work to First Boston Corporation for its services in advising Texaco in its bid for Getty Oil. (That comes out to just over $126,582 an hour); $18.5 million to Goldman Sachs in the same deal. In the Gulf deal $29.6 million to Salomon Brothers, $16.5 million to Morgan Stanley, and $18.9 million to Merril Lynch. And $5–6 million to Lehman Brothers for representing Allied in the Martin Marietta-Bendix-Allied-United Technologies deal.

With respect to the lawyers, the fees are not as widely publicized, but in one recent case the fees paid to attorneys for a conqueror exceeded $7 million.

Now I do not begrudge an honest person an honest day's pay for his or her work, but in these particular instances there is a larger principle at stake. That is whether we are paying some of this country's best talent unbelievable sums of money for an essentially nonproductive purpose. After all, tender offers per se create no new wealth; they simply reallocate existing wealth, moving it from the shareholders of the offerer to the shareholders of the target. No new plants are built, no jobs created, no wealth enhanced except that of the shareholders of the target and the attorneys and investment bankers for both sides.

This same feeling has been expressed by Noble prize-winning Yale economics Professor James Tobin who confessed not too long ago "to an uneasy suspicion we're throwing more and more of our resources, inlcuding the cream of our youth, into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity."

Just last Tuesday Warren A. Law, the Edmund Cogswell Converse Professor of Banking Finance at Harvard Business School, testified that "There are reasons for being skeptical about the long-run social gains from takeovers" and listed as one of his many reasons a concern about the "brain-drain" being diverted to this "game". He said:

"Increasing amounts of our scarcest resource—brain power—are being devoted to playing games. Our brightest young people are being lured into this game by the inordinate legal and financial fees involved. And good managers are forced to spend time in unproductive ways, to avoid being raided, rather than activities of social benefit."

FINANCING OF TAKEOVERS

Another aspect of the hostile takeover phenomenon which bothers me is the almost instantaneous availability of funds to finance some of these deals when credit is not nearly so readily available for other economic purposes.

For example, it is difficult for me to comprehend how Carl Icahn can send Drexel Burnham Lambert out to raise $4 billion as part of an $8 billion proposal to take over Phillips Petroleum; or how the leveraged buyout firm of Kohlberg Kravis Roberts and Co., which came close to buying Gulf, could assemble $6 billion of bank loan commitments for a deal that would have had a debt-equity ratio of 30 to 1.

Still another example involves William Farley—hardly a household name—who raised $90 million through Drexel last year for his hard-fought takeover of Condec Corp., A Connecticut producer of high-tech components and military gear. Says Farley: "When I started (buying companies) in 1976, no one was really geared up to finance this stuff. Today we could go out and raise probably $2 billion in two days."

I am amazed at the ease with which some people raise money for these types of activities while for other simpler and more productive purposes ordinary consumers cannot even get a loan.

According to recent articles in the financial press, "junk bonds" have become an increasingly popular means of raising money to fund these multi-billion dollar corporate takeovers and leveraged buyouts. It is my understanding that the risks of investing in these issues are rising and that losses to investors from bankruptcies in 1984 were more than double the combined losses from 1976 to 1983.

In the event that there is a default on some of these bonds in the future a number of our nation's financial institutions may be adversely affected.

I am particularly concerned about stories of problem savings and loan associations having invested in these bonds and have written Chairman Edwin Gray of the Federal Home Loan Bank Board requesting the following information from the Board:

(1) To what extent have federally insured savings and loan associations been investing in these junk bonds?

(2) To what extent are problem thrifts investing in these bonds?

(3) What is the Board's position as to whether these bonds are a proper investment for federally insured savings and loan associations?

(4) What threat, if any, do these instruments pose to the integrity of the FSLIC?

(5) What actions, if any, does the Federal Home Loan Bank Board anticipate taking with respect to the regulation of these bonds as they relate to savings and loan association investment in them?

Commercial banks as well as thrift institutions are involved in this activity and Citibank, First National Bank of Boston, and Security Pacific are among those banks that have financed individuals in their run on corporations.

It is interesting to note that in the case of Security Pacific, just last week on March 12, Unocal Corporation and Union Oil Company of California filed a lawsuit against Security Pacific alleging, among other things: fraud, negligent misrepresentation, breach of contract, breach of fiduciary duty, breach of good faith and fair dealing, and misappropriation of trade secrets. It turns out that after a relationship of some 40 years, in which Security Pacific continually received confidential financial, geological and engineering information from Unocal, the Bank turned around and loaned money to a group intent on taking Unocal over or putting it into play as an acquisition target.

I wonder how many other cases there are in which banks are playing both sides of these deals at the same time.

As I mentioned earlier, one way to inhibit the current surge in unfriendly takeover activity is for the financial institution regulators to urge lenders to slow down their financing of such activity. I anticipate that the regulators will do so regardless of the outcome of the current debate over hostile takeovers.

MINNOWS VS. WHALES

Still another apsect of the unfriendly takeover game that I find puzzling and disconcerting is the number of individuals and comparably small companies going after major institutions many times their size. According to Jay F. Higgins, head of Salomon Brothers' merger department, "Big companies used to worry only about take overthreats from other big companies." But now, according to Michael D. Brown, Drexel's West Coast merger chief, "We take a minnow, identify a whale, then look to its assets to finance the transaction."

To me there is something inherently fishy about a system that allows this to take place on an almost daily occurrence, and in fact encourages the practice by not inhibiting it.

Take the real life example of an individual who has never actually acquired a major corporation. He runs his own with 650 employees and sales of $413 million. That individual, with his comparatively small, minnow of a company, goes after companies with $8.5 billion in sales, $28.4 billion and $11.5 billion to list but a few of his prey. unsuccessful in these escapades at control he pockets $978 million in pretax gains in the process. Does it make sense? To me it does not.

What it does is it distracts corporate managers from running their businesses and forces them to spend great sums of money and time fighting off attacks. As a result, accoriding to a March 11, 1985 article in Forbes, "companies are sometimes led to doing preverse things to avoid rape. They may overpay for an acquisition in order to make themselves less sexy to protential rapists. Or they may load up their balance sheet with debt to make themselves less attractive." Other results and business strategies are as follows:

Less money is going into startup ventures and more into acquisitions of existing assets.

Companies spend more research money on improving processes and less on developing new products.

Investment is shifting from busineess with high capital needs to businesses with low needs.

More and more companies are selling assets to managers and investors who finance with debt.

While companies once replenished their capital by selling new equity to investors, they now are buying their own stock.

Resource companies are emulating manufacturers—investing less in exploration, more to buy existing reserves.

Corporate America is resorting to defensive battle tactics and policies with such esoteric names as the Pac-Man defense, scorched earth policy, shark repellants, poison pills, and golden parachutes. All such business strategies are costly and it has yet to be proven to me that the benefits of these hostile takeovers outweigh the costs. Since the cost is considerable it is my opinion that the burden should be on the perpetrator to justify the benefits rather than the other way around as is currently the case.

INTEGRITY OF THE MARKETS THREATENED

Another result of this takeover activity is an increasing skepticism among ordinary investing Americans about the integrity of our marketplace. Over a year ago on January 25, 1984 the New York Times had a front page story on its business page entitled "Wall Street Worries Over Insider Leaks". The story began:

"Some Wall Street executives are expressing a growing concern that the wave of corporate mergers in recent years has spawned a pattern of illegal insider trading in stocks of companies that receive takeover bids. Such trading, it is believed, has reached sizable proportions and, if allowed to continue, could tarnish the credibility of the securities markets."

Market price fluctuations preceding and surrounding a tender offer have in fact led to heightened concerns about insider trading. In addition, small shareholders in many respects believe that there is no longer a place for them in a market dominated by big institutions, arbitragers and takeover entrepreneurs. Many believe the market is "rigged", and this ultimately has led to a decrease in confidence in the capital markets.

This perception has been enhanced by recent events. The fact that both former U.S. Treasury Secretary John B. Connally and T. Boone Pickens have been named in separate lawsuits during the past few months as having been allegedly involved in possible insider trading infractions involving hostile takeover situations—whether these allegations are true or not—does nothing to ensure confidence in the integrity of our markets among the everyday investor and the public at large.

The lawsuit by American Natural Resources charged that Connally—whom Coastal has proposed as an ANR director—bought 4,000 ANR shares in February after being "tipped" that Coastal was about to launch its bid.

The lawsuit against Pickens filed by Phillips and reported on December 12, 1984 alleged that Pickens in the past had tipped friends and associates as to his takeover bids in advance.

Now I want to make clear that I have no knowledge whatsoever as to the truth of these particular charges. But then there are the very real highly-publicized insider trading takeover cases brought against high-ranking Administration officials Thomas Reed of the National Security Council and Paul Thayer of the Defense Department.

These case and numerous others have resulted in a climate where a number of people now believe that the days are over where the individual nonprofessional investor can feel comfortable and roughly on a par with the market professional in investing in our markets. I am not willing to accept that outcome and believe that the fact that there is this growing perception that hostile takeovers are marked by insider trading, market manipulation and the fleecing of small investors is yet another reason for restricting hostile takeover activity.

I must say that I am also not encouraged as to the wisdom of these takeovers when I read the following commentary in the Times written by an unidentified arbitrager. This obviously successful investor writes:

"These mergers drain the capital markets and have a markedly unhealthy effect on the stock market. When the real money is made through mergers, too many

people concentrate on figuring out the next deal rather than on trying to find values, and a whole lot of good companies can't find capital.

"Plus you have a whole class of instigators and parasites that promote and feed on this process, of which I guess I am one. Seven-figure incomes are common in this business, but that's not so harmful—a bunch of baseball players make that. It's what they do that bothers me.

"The merger and acquisition departments of the investment banks are playing a very destructive role. The size of the fees remove any objectivity about the merits of a deal. Everyone wants to do deals. Unlimited partners call up and say why can't we do some greenmail, let's put together a syndicate and buy of a piece of some company. . .

". . . People are tossing around companies like they were sardines, but we're talking about dislocation of employees, communities, production and hundreds of thousands of jobs."

CONSTITUENCIES OTHER THAN SHAREHOLDERS

It is this last point that may be the most important of all in this whole debate over tender offer reform.

For years, the debate over corporate takeovers has been focused somewhat narrowly on the rights of shareholders: The main thrust of the Williams Act is to give shareholders sufficient time and information to evaluate takeover bids. Proposals to amend the Williams Act have often been analyzed as to how they affect shareholders. Academic studies attempting to quantify the benefits of takeovers have centered on the increase in stock prices as a result of the takeover process. The recent report of the SEC Advisory Commission on Tender Offers dealt mainly with stockholder rights.

Now, stockholders are certainly an important group whose interests deserve to be protected. But there are other interested parties in the takeover process as well as a company's stockholders. These include the company's employees, pensioners, its community, its customers, its suppliers, and all those in the chain of distribution of a company's products and services. And increasingly, the economy and the society at large have an interest in the corporate takeover process. If hostile corporate raids and takeovers undermine managerial productivity, encourage excessive debt and discourage productive long-term investments as some suggest, then the issue goes well beyond the rights of shareholders.

Clearly, the takeover issue has moved well beyond the narrow confines of specialists in securities law. In a very real sense, the takeover process affects the average guy on the street whether he or she owns stock or not. We all have a stake in seeing our economy perform well in competition with our major trading partners. If our top manages are spending most of their time playing the takeover game while their foreign counterparts are figuring out how to produce better products or services, we all suffer. And so it is time to expand the takeover debate into a larger arena.

The Securities and Exchange Commission is the appropriate governmental agency to argue the merits of tender offer reform on shareholder interests. But there are many merger pitfalls which fall beyond the jurisdiction or expertise of the Commission to consider. These include the effect of unfriendly mergers on employees and company productivty and morale in the aftermath of such a takeover. In the opinion of Henry G. Van der Eb, the retired chairman and chief executive officer of Container Corporation of America.

"The corporation's employees are at least as 'primary' as the 'shareholders' capital being inert without labor.

"Although the acquiring company and its shareholders pay the cost of the acquisition, the real 'price' of the merger is often borne by the employees of the acquired organization and its various constituencies in the community at large.

"Too frequently, the momentum and intangible strengths of an acquired corporation are taken for granted. Ultimately the dead hand of a superimposed bureaucracy takes its toll, stultifying initiative and inhibiting innovations. Morale and productivity wane. Much of the economic rationale of buying underprices physicial assets in the first place can later be negated by the loss of motivation and sense of identity in the acquired company."

This issue, together with how hostile takeovers and tender offer reform are likely to effect America's competitiveness in the world, the productivity of our corporations and the impact on our domestic economy, is a subject that msut now be debated by Congress.

SUMMARY

In summary, I have listed above a number of reasons for wanting to inhibit hostile takeover activity and am introducing the Corporate Productivity Act of 1985 to accomplish that purpose in certainly narrowly defined instances.

I have mentioned my concerns about the leveraging of corporate America; the short-term horizons of our mergers; and some of the effects of hostile takeovers on our economy.

My conclusion is that hostile takeovers for the most part are not serving our vital national interests and that it is time for Wall Street and corporate America to refocus their attention on more productive and beneficial activity.

I look foreward to full consideration being given my proposal in the near future in the upcoming hearings on tender offer reform to be held in the Securities Subcommittee of the Senate Banking Committee on April 3, 1985. I also look forward to legislation being enacted on this subject during the course of this Congress.

Chairman PICKLE. In your statement, you said at page 3, that last year alone, this country experienced a net loss of $90 billion in equity capital, which was replaced with debt on corporate balance sheets.

What is the source of your information, your figures?

Senator PROXMIRE. That statement was made by Henry Kaufman of Salomon Brothers, who has been reliable in the past, and I accepted his statement.

Chairman PICKLE. All right. His voice is certainly to be remembered and reckoned with, sir. I noticed that you also said that you have——

Senator PROXMIRE. May I just say, Mr. Chairman, Paul Volcker says $85 billion, which is in the same neighborhood.

Chairman PICKLE. You said you had written the Federal Reserve Board Chairman Paul Volcker with respect to discouraging the banks from making these kinds of loans or participating in these junk bonds deals.

Have you heard anything from Mr. Volcker on that letter you wrote him? When did you write him and have you heard back yet?

Senator PROXMIRE. We got a general replay back from Mr. Volcker. We have not heard from the Bank Board as yet. We will be happy to provide the letter for the committee.

Chairman PICKLE. I noticed also you quote Mr. John Shad, the Chairman of the SEC, and the Federal Reserve Board Chairman, Paul Volcker. Each have publicly warned of the consequences of this leveraging of corporate America.

You termed it the defunding of America. Apparently, they have strong feelings about this. We may have them before this subcommittee.

Mr. DORGAN. What was the general reply? We pretty much get a general reply to everything we request from the Fed?

Senator PROXMIRE. I have a lot of admiration and respect for Paul Volcker, but this was a general response in this case. I will be happy to make the letter available to you.

Mr. DORGAN. Thank you.

[The letter follows:]

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC, April 4, 1985.

Representative J.J. PICKLE,
Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, DC.

DEAR REPRESENTATIVE PICKLE: Enclosed is a copy of replies I received from Paul Volcker to questions I asked at a hearing we held on February 20. I would like to have this document included for the Record of the April 1, 1985 hearing at which I testified on mergers and acquisitions.

Thanking you in advance for your cooperation, I am

Sincerely,

WILLIAM PROXMIRE,
U.S. Senator.

Enclosure.

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM,
Washington, DC, March 12, 1985.

Hon. WILLIAM PROXMIRE,
U.S. Senate, Washington, DC.

DEAR SENATOR PROXMIRE: I am pleased to respond to your written questions submitted in connection with the Senate Banking Committee's February 20 hearing on monetary policy. Your questions concern the amount of debt resulting from leveraged buyouts and our views on leveraged buyouts and other merger-related activity.

In 1984, nonfinancial corporations liquidated an estimated $85 billion in equity through mergers, leveraged buyouts, and share-repurchase programs. Only a small portion of these retirements—probably less than one-quarter—were financed by new equity or noncredit sources. The remainder were financed with debt, including a large amount of short-term bank borrowing. Based on flow of funds estimates, borrowing for all merger-related retirements contributed perhaps 1 percentage point to the 13½ percent growth in domestic nonfinancial debt in 1984.

Equity retired through leveraged buyouts, per se, totaled about $12 billion last year, based on available estimates. As implied by their name, these transactions entail high levels of debt, a large share of which has been extended by banks. The high volume of debt relative to equity involved in these transactions raises concerns from a supervisory perspective over the potential risk for firms involved in the activity and for the lenders providing the credit.

Typically in a leveraged buyout, the debt is collateralized in part by the assets of the acquired entity—often inventories or accounts receivable. The success of the buyout and the ability to service the debt hinge significantly upon the future earnings stream and cash flow prospects of the new company. In many cases the debt may carry a variable interest rate. Thus, a heavily leveraged firm will be vulnerable to adverse economic events that might alter the projected stream of cash flow or to unexpected pressures in financial markets that raise interest rates and the cost of servicing the debt. The value of collateral also would be affected by changes in the economic environment. To the extent that leveraged buyouts weaken balance sheets and increase the exposure of firms to market risks, they raise concerns as well about the risks for institutions providing the credit.

For these reasons, the Federal Reserve has actively urged banks to be fully mindful of the potential risk in evaluating loans for leveraged buyouts and to ensure that prudent lending standards are applied. Specific guidelines have been issued for bank examiners to follow in reviewing a bank's involvement in leveraged buyout financing. A copy of Federal Reserve guidelines is enclosed. The Board will, of course, continue to monitor these and other types of merger activities and associated lending practices. I would hope also that the investment community will apply caution in appraising various types of financial arrangements, such as junk bonds, that are being used by companies involved in takeovers and other merger transactions.

As noted in the Business Week article that you cited, the recent merger activity and heavy borrowing has been incurred during a period of strong economic growth and lower interest rates. To my knowledge, there have been on failures of note or defaults on debt by firms involved in recent large transactions. Some of these companies have begun to restructure their balance sheets, in some cases by selling off assets and repaying debt or funding short-term debt with other sources of financing. Nonetheless, in the event of a recession or sharply higher interest rates, some acquiring firms, or firms taken privately through leveraged buyouts, no doubt would find their heavy debt to be quite burdensome. But prudent lending practices, as out-

lined in our guideline and established by lenders, take these eventualities into consideration, and if sound practices are followed, failures associated with heavy leveraging will occur only in exceptional cases.

Sincerely,

PAUL.

Enclosure.

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM,
Washington, DC, June 7, 1984.

To: The Officer in Charge of Examinations at Each Federal Reserve Bank.
Subject: Leveraged Buyouts.

Leveraged buyouts have become an increasingly important and prevalent acquisition financing technique which, by definition, entail high levels of debt. Bank involvement in leveraged buyouts and the manner in which some leveraged buyouts have been structured have potential implications for the quality of bank loan portfolios. Examiners should be aware of the characteristics of this financing technique and its potential effect on a bank's loan portfolio and overall financial condition.

GENERAL BACKGROUND

Although leveraged buyout arrangements may vary from case to case, they typically have a number of characteristics in common. Generally, each involves the financing of an acquisition of a company, or a subsidiary or division of a company, by a group of private investors and/or company managers. Normally, the investors or managers put up a relatively small amount of equity, borrow heavily against the company's assets and future cash flow and buy out existing owners or shareholders. Often at least a portion of the debt is secured by the assets of the acquired entity, generally accounts receivable or inventory. In particular, the financing arrangements usually include (a) senior debt, secured or unsecured, often provided by banks and other institutional lenders and representing the largest share of the buyout financing; (b) subordinated debt and/or preferred stock in the form of paper taken back by the seller; and (c) common equity supplied by the new owners. Debt levels amounting to seven to ten times equity and more are not unusual in leveraged buyout situations. The viability of leveraged buyouts is predicated upon the strength, stability and future prospects of the earnings and cash flow of the acquired entity.

Once a company has been acquired in a leveraged buyout its assets and liabilities are revalued at market value. This usually results in a write-up of asset values, and, consequently, a higher amount of depreciation expense than before the buyout. These higher depreciation charges, coupled with the large interest expense deductions on the acquisition debt, reduce the taxable income associated with the purchased company and, therefore, reduce the income taxes that the company must pay. Most leveraged buyout companies pay little or no income taxes during the first few years after the transaction.

Banks participating in financing these arrangements often earn an upfront fee of ½0 percent to ¼ percent while the agent bank may take an additional ¼ percent annually for monitoring the collateral and handling the paperwork. Banks have extended both secured and unsecured loans for leveraged buyouts in the form of revolving credits and term loans. These loans may carry a fixed or variable interest rate ranging from prime plus 1¼ percent to prime plus 2½ percent for senior debt and prime plus 3 percent at a minimum for subordinated loans. Some loans have been structured in such a way as to require the payment of interest only for the first two or three years following the buyout. In addition to these primary loan facilities, banks may extend ancillary lines of credit which may be drawn upon only for the payment of interest, usually when interest rates on variable rate primary loans exceed a certain pre-determined "cap" rate. While intended to provide the borrower some initial temporary protection from unfavorable interest rate movements and heavy debt service obligations, these arrangements could mask emerging debt service problems and postpone the timely recognition of potential credit weaknesses in a bank's loan portfolio.

SUPERVISORY CONSIDERATIONS

The nature of leveraged buyouts and, in particular, the level of debt typically involved in such arrangements give rise to supervisory concerns over the potential risk implications for bank loan portfolios. The high volume of debt relative to equity that is characteristic of leveraged buyouts leaves little margin for error or cushion

to enable the purchased company to withstand unanticipated financial pressures or economic adversity. Two principal financial risks associated with leveraged buyout financing are: (1) the possibility that interest rates may rise higher than anticipated and thereby significantly increase the purchased company's debt service burden; and/or (2) the possibility that the company's earnings and cash flow will decline or fail to meet projections, either because of a general economic recession or because of a downturn in a particular industry or sector of the economy. While either one of these developments can undermine the creditworthiness of any loan, the high degree of leverage and the small equity cushion typical of most leveraged buyouts suggest that economic or financial adversity will have a particularly large and negative impact on such companies. Thus, a leveraged buyout arrangement that appears reasonable at a given rate of interest or expected cash flow can suddenly appear to be questionable if interest rates rise significantly or if earnings should fail to provide an adequate margin of coverage to service the acquisition debt.

In addition unfavorable interest rate movements and earnings developments, adverse economic conditions may also have a negative impact on the value of a company's collateral. For example, if a general economic slowdown reduces a company's sales and earnings, the marketability and value of its collateral may also suffer. In any event, given the amount of debt involved in leveraged buyouts, the value of collateral is extremely important, and the risk that collateral coverage may be insufficient to protect the bank is a significant factor in evaluating the creditworthiness of these loans. In light of all of these considerations, the quality of a purchased company's management is also extremely important and represents another critical element in the bank's evaluation of leveraged buyouts. This is because such management must oversee both the special financial risks associated with the leveraged buyout form of acquisition financing as well as the normal day-to-day affairs and operations of the purchased company's business.

In the course of on-site examinations, examiners should review a bank's involvement in leveraged buyout financing as well as the loans associated with individual leveraged buyouts. The following general guidelines are provided to underscore and supplement existing loan review procedures.

1. In evaluating individual loans and credit files, particular attention should be addressed to: i) The reasonableness of interest rate assumptions and earnings projections relied upon by the bank in extending the loan; ii) the trend of the borrowing company's and the industry's performance overtime and the history and stability of the company's earnings and cash flow, particularly over the most recent business cycle; iii) the relationship between the company's cash flow and debt service requirements and the resulting margin of debt service coverage; and iv) the reliability and stability of collateral values and the adequacy of collateral coverage.

2. In reviewing the performance of individual credits, examiners should attempt to determine if debt service requirements are being covered by cash flow generated by the company's operations or whether the debt service requirements are being met out of the proceeds of additional ancillary loans from the bank designed to cover interest changes.

3. Policies and procedures pertaining to leveraged buyout financing should be reviewed to ensure that they incorporate prudent and reasonable limits on the total amount and type (by industry) of exposure that the bank can assume through these financing arrangements.

4. The bank's pricing, credit policies and approval procedures should be reviewed to ensure i) that rates are reasonable in light of the risks involved and ii) that credit standards are not compromised in order to increase market share. Credit standards and internal review and approval standards should reflect the degree of risk and leverage inherent in these transactions.

5. Total loans to finance leveraged buyouts should be treated as a potential concentration of credit and if, in the aggregate, they are sufficiently large in relation to capital, the loans should be listed on the concentrations page in the examination report.

6. Significant deficiencies or risks regarding a bank's leveraged buyout financing should be discussed on page 1 of the examination report and brought to the attention of the board of directors.

This interim letter sets forth some general considerations and draft guidelines for use in reviewing leveraged buyouts. Reserve Banks are instructed to carefully review a bank's leveraged buyout financing activities and to forward comments and suggestions for modifying, expanding or strengthening these procedures as additional experience is gained in appraising these credits. Enhanced guidelines will be pro-

vided in the future. Comments or questions may be addressed to Richard Spillenkothen or Jerry Edwards.

JOHN E. RYAN,
Director.

FEDERAL HOME LOAN BANK BOARD,
OFFICE OF POLICY AND ECONOMIC RESEARCH,
Washington, DC, April 5, 1985.

Hon. WILLIAM PROXMIRE,
U.S. Senate, Washington, DC.

DEAR SENATOR PROXMIRE: Chairman Gray asked me to respond to your letter regarding holding of "junk bonds" by savings institutions. It was the opinion of our General Counsel that I should respond to your letter, rather than the Chairman, since various regulatory approaches to the "junk bonds" issue are currently being discussed by the Board Members, and since the appearance of any decision by the Board Members prior to the end of the formal comment period could raise legal challenges to those regulations. I discussed these matters with Ken McLean who indicated that this approach was agreeable.

The holding by savings institutions of high-yield bonds raises a number of difficult policy issues which the Board is seeking to address. Unfortunately, at the current point in time, we have only an approximate estimate of the amount of total high-yield bond holdings by savings institutions, which we estimate to be in the range of $3-5 billion. Our quarterly financial reports required by every FSLIC-insured institution will require reporting of high-yield bond holdings, beginning with first quarter 1985 reports, due at the end of this month. Within six to eight weeks we should have a fairly precise handle on total high-yield holdings by savings institutions.

Complicating any possible regulatory response by the Federal Home Loan Bank Board is the data on defaults and losses experienced by high-yield bond holders. While there is clear evidence that unrated corporate debt securities or securities rated below the top four ratings of the major rating agencies have higher default and loss ratios than bonds rated investment grade, the loss ratios on high-yield bonds seem to correspond fairly closely with the loss ratios on regular commercial loans issued by money center banks. This is not surporising, sincethe only real differences between unsecured commercial loans and high-yield bonds is that the latter are securitized and offered to the public for purchase. This is not to say that investment in these securities is "low-risk. It does indicate, however, that precluding the holding of high-yield bonds by savings institutions on the grounds of "safety and soundness" could be deemed to be arbitrary in the absence of data to substantiate the assertion of excessive risk.

This should not indicate any degree of comfort by the Bank Board in regard to high-yield bond purchases by savings institutions. The rapidly growing high yield market opens a relatively new high risk investment strategy for savings institutions. Although "junk bonds" have a long history, recent innovations have dramatically changed the nature of the market, with unknown future consequences. The incentive for risk taking by savings institutions with low capital and government insured liabilities is of tremendous concern to us. Development of the "junk bond" market presents a new vehicle for savings institutions to increase portfolio risk and return.

Nevertheless, the most troubling aspect of "junk bond" purchases by savings and loan institutions is a philosophical one. It is a common consensus that savings institutions are primarily intended to be vehicles for home financing, and that the purchase of high yield bonds are inconsistent with that purpose. Nevertheless, mandating the "appropriate" function of savings institutions by Bank Board regulations is difficult, if not impossible. Soon after adoption of the Garn-St Germain Act, our Office of General Counsel opined that corporate debt securities fall into the ten percent commercial lending basket provided for Federally-chartered saving institutions. State-chartered institutions, some of which have close to unlimited commercial lending authority, are authorized to purchase high-yield debt securities in excess of the Garn-St Germain limit of ten percent. Not surprisingly, the anecdotical evidence indicates that the largest savings institution players in the high-yield bond market are state-chartered.

You and Chairman Gray have discussed the tremendous problems resulting from the inconsistent standards applied by the dual system of regulating state and federally chartered institutions, while at the same time providing Federal deposit insurance for all. What we predict to be rapidly growing purchases of high-yield bonds by state-chartered institutions further illustrates this phenomenon.

Although our hands may be at least partially tied from prohibiting the purchase of high-yield bonds completely, I do not mean to imply that we have no avenues for constructive regulation. The Bank Board staff is in the process of proposing fairly stringent diversification requirements regarding the holding of corporate debt securities. Perhaps more importantly in the long-run, we are proposing that the Board adopt fairly stringent guidelines for our examiners and supervisory agents to use when determining whether to force savings institutions to write off portions of unsecured commercial debt obligations, both bonds and routine loans, as prospectively uncollectible. These measures could have salutary affects, although I seriously doubt that they will be of sufficient magnitude to render moot the philosophical issue of whether savings institutions should hold high-yield corporate bonds at all.

I will stay in touch with Ken McLean as we receive precise data on high-yield bond holdings from our quarterly reports. In the meantime please feel free to have Ken contact me if I can provide additional assistance.

Sincerely,

ERIC I. HEMEL,
Director.

Chairman PICKLE. Are you familiar with the legislation which Senator Boren and Congressman Jones have introduced which puts an excise tax on greenmail?

Senator PROXMIRE. Certainly not as familiar as Mr. Boren, but I am cosponsoring that legislation in the Senate, and I agree with Mr. Boren on its merits.

Chairman PICKLE. Have you introduced legislation on this subject?

Senator PROXMIRE. I am simply cosponsoring the Boren bill.

Chairman PICKLE. I am going to yield to other members and come back to you for questions, but I think your testimony was extremely helpful to us, Senator.

Mr. Rangel.

Chairman RANGEL. Thank you, Senator, for sharing your views with us. We are all really trying to target abuses without unnecessarily disrupting provisions in the Tax Code. Most of the witnesses are using words like unfriendly, raider, and hostile, and so, I assume that there is a difference between corporations or those people who put together deals that both parties agree.

My question is, suppose you did find a company that wanted to buy out another company, and we will call the other company "victim," and that the raider and the unfriendly and the hostile company wanted to borrow large sums of money in order to target the stockholders of the victim company, and also take advantage of the net operations, losses, in order to be able to write that off.

But that their goal was not only to be able to write off the interest payment and to enhance the position of the raider company, but they thought they could do a better job in management.

They thought they could expand and create jobs, and they wanted to do it, not only for fast profit, but also because they thought they could do a better job than the so-called victim company that was very unfriendly to them.

Would you object to that?

Senator PROXMIRE. I wouldn't stop any kind of a takeover. It can happen, and the bill I have introduced would provide a little greater institutional protection. Anyone with 15 percent of the stock of a company could not buy any more without submitting a formal tender offer to the board of directors.

If the independent directors reject the proposal, it would then have to be approved by a two-thirds vote of all the company stock-

holders, and if two-thirds of the stockholders approve, the tender offer can be submitted to all of the stockholders. The stockholder vote would take place over 60 days.

Today, it is too easy to panic the stockholders, and they sell. Under my bill there would be more deliberation involved, and a majority of the independent directors would have to approve.

Chairman RANGEL. They could provide in their charter for treatment—I mean—the lack of respect they have for their stockholders and whether or not there should be a check with them before you are a victim of greenmail.

We should not have to tell the corporation what they can or cannot do with their stock.

Senator PROXMIRE. Congressman Rangel, you may be right about this, but as I understand it, if somebody wants to take over a corporation, under present circumstances, they can move in even though it is opposed by the board unanimously, and buy a majority of the stock of the corporation, and take it over.

Chairman RANGEL. They have to buy it from a stockholder?

Senator PROXMIRE. Sure, but my proposal would say that they would not be able to do this, if the independent directors reject the proposal. Then they would have to get a two-thirds vote of the company stockholders before they could begin to buy the stock.

Then, of course, they could do so.

Chairman RANGEL. You make it friendlier. I suppose the victim company does not want to sell anything, they don't like the raider and they think they are doing pretty good, and they don't want to be swallowed up by this unfriendly corporation.

The unfriendly corporation, in my scenario, may not appear to be nice. They think they can do a better job and create some jobs for the community and expand the R&D and take advantage?

Senator PROXMIRE. Under those circumstances, the people who want to take over the corporation could do so if they could persuade two-thirds of the stockholders to vote in favor of the takeover.

My bill does not stand by itself. As I say, I am cosponsoring the Boren bill and there will be bills introduced in the House by others. I am on the Banking Committee, so as far as the protections against this in the Tax Code, that is your business, not mine.

Chairman RANGEL. Thank you, Senator.

Chairman PICKLE. Mr. Schulze.

Mr. SCHULZE. Thank you, Senator, for appearing. Although you are only our second witness, I am perceiving a pattern of more and more reliance on the so-called independent director. How independent is an independent director when he is selected by the existing board?

Senator PROXMIRE. Mr. Anthony raised the same point earlier.

Mr. SCHULZE. He might be an attorney for one or several of the members of the board. Before long, if we put this in some sort of law, there would be no independent director.

It is improbable to think a corporation is going to allow the independent directors to come in and run the corporation, no way will that happen.

Senator PROXMIRE. That is a very, very good point, Mr. Schulze, and what I am trying to do is the best I can, and that is what we

have to do here. It is an imperfect proposal. But we have to be very careful about interfering with a decision to be made by the company itself, and all I am doing is trying to create an institutional situation that will slow down the hostile takeover and cause the stockholders to think twice and require a somewhat bigger majority.

Mr. SCHULZE. We would be giving these individuals an awful lot of power, and there would be ways to get around that. Don't the State laws vary on independent directors?

Senator PROXMIRE. You are right. If you can show me how I can strengthen this proposal I will be for it. Nonetheless, independent directors are not paid by the company except as directors. They are not paid as employees, so they are not under the thumb of the chairman of the board; and they are in a position to know the company.

They are directors, and they have that degree of expertise, so if you are going to have some kind of institutional protection against hostile takeover and not have it imposed by the SEC or some outside agency, it seems to me that this one way to proceed.

It is imperfect, you are right.

Mr. SCHULZE. I thank the Senator.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Flippo.

Mr. FLIPPO. Senator, thank you for your testimony.

Senator, managers of corporations are disturbed about these takeovers, as you have described in your testimony. Stockholders hold a different view from management on whether or not these takeovers are beneficial.

When you have a divergence of opinion between managers and stockholders, as to the proper course of action for the corporation to take, whose interest do you feel the Government should be looking after?

Senator PROXMIRE. Mr. Flippo, the stockholders own the company and should make the final decision, and in my proposal, they do. I would require a larger proportion of the stockholders to make that decision in view of the clear, obvious adverse effect this has in increasing the debt of our companies, discouraging research and development, and in being excessively preoccupied with quarterly earnings. All these things have hurt, I think, the productivity of American business.

And this is one way of overcoming it, but you are right, my proposal would leave the final decision with the stockholders, and it should be. They own the company. It is theirs.

Mr. FLIPPO. In reading over your testimony, I got the idea that you were listening far more to management than you were to stockholders as to the proper course of action to take there. I didn't think your past history would indicate that, and I wanted to clarify whether or not you were coming down on the side of managers who oppose this or stockholders who favor it?

Senator PROXMIRE. My proposal does tend to come down on the side of managers, but put yourself in the situation of a stockholder.

Frankly, it would be delightful for me to have Mr. Pickens or Mr. Icahn or somebody come along and raise my stock 100 percent, and I could make a nice big profit without doing much.

Looking at the long-term consequences, we have to work out something to preserve the basic business fundamentals for the stockholder and provide an opportunity to slow down what seems to be the harmful effects of hostile takeovers.

Mr. FLIPPO. The exchange of debt capital for equity capital that has taken place. Hostile takeovers and breakup liquidation takeovers are saddling corporate America with excessive debt. I believe the friendly takeovers involve themselves in a great deal of substitution of debt capital for equity capital as well.

Senator PROXMIRE. Yes, most of these proposals are modest.

Mr. FLIPPO. Don't you believe that one of the reasons that you are seeing so much substitution of debt capital for equity capital is the result of tax advantages that come from debt capital, the way the present code prefers and permits the deduction on debt capital as opposed to equity capital?

Senator PROXMIRE. I am sure that is the case. I understand the administration has proposed to provide for some amelioration of that. That is your area of expertise, not mine, and I am sure that you can improve the situation by studying the Tax Code and making it more neutral.

Mr. FLIPPO. Would the Senator favor a neutral Tax Code?

Senator PROXMIRE. Absolutely.

Chairman PICKLE. Mr. Vander Jagt.

Mr. VANDER JAGT. No questions, Mr. Chairman.

Chairman PICKLE. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

Senator Proxmire, I just have one clarifying question. On page 1, you talk about the multitude of things that you think are wrong with hostile takeovers. You use the phrase "cheat shareholders," and I don't find it expanded on anyplace in your testimony. I am curious what you are making reference to, and I would like you to include an explanation of how your viewpoint may differ from a story that was printed in one of the magazines called "The Raiders." In this article one of the raiders is fond of saying that he has increased to about 750,000 shareholders, $13 billion, thanks to his raids on four big oil companies. He even saying he gets letters every day stating, "Dear Mr. Pickens, have you thought about our company?"

Senator PROXMIRE. Mr. Anthony, you are very perceptive, because what you suggest does the balance of what I say here. Many shareholders make out like bandits. If I as a stockholder could increase the value of my shares 100 percent, that is great.

But, in the long run, because the company tends to be less dynamic and all the other things, the shareholders could be cheated.

In the short run, some shareholders do well, that is right.

Mr. ANTHONY. You are challenging this committee to look at whether or not the Tax Code should, in the short term, encourage these types of nonproductive economic activities. Obviously, we could say to 750,000 shareholders that they want to be greedy over the next 6 months, a little extra money could be put in their pocket. But you stated a company heavily in debt might not have a whole lot.

If we see another drop in oil prices, they may end up with a pretty bad bill, although in the short term, it won't look bad. With

oil prices stable and falling right now, they could have gotten themselves in some trouble.

Senator PROXMIRE. You are exactly right, I agree with that, yes, sir.

Mr. ANTHONY. Thank you for taking the rifle and shooting right at the core of the problem. Hopefully, we can find a way so that the Tax Code is treated equitably to all groups.

Senator PROXMIRE. Thank you very much.

Chairman PICKLE. Mr. Dorgan.

Mr. DORGAN. Just a brief question, Senator Proxmire.

On page 6 of your testimony, you indicate that one approach to try to dampen some of the activity is for bank regulatory agencies to jawbone and discourage banks and other financial institutions from making loans or purchasing junk bonds, and you have written the Federal Reserve Board.

We have had an exponential increase in mergers and acquisitions and that has involved an incredible use of scarce credit, at the same time, many of your farmers in Wisconsin are desperately searching for funds.

I have written the Federal Reserve Board and received the same general answer, and I have written to Federal regulatory agencies, and so on. Do you hold out any hope for that second approach?

Do you believe without some Federal legislation to deal with the questions we are talking about here, mergers and acquisitions generally, the question of the use of credit, that the banking industry, the regulatory agencies, the Fed will get involved in any sort of way in this?

Senator PROXMIRE. The regulators have a whale of a lot of influence with the banks, if they want to really crack down, and the Federal Reserve Board, Mr. Volcker and others, do recognize how perverse and unfortunate this kind of situation is, and they certainly recognize how dangerous the heavy debt of American corporations is at a time when the Federal Government is getting shamefully in debt, how bad that can be, in the event we move into a recession.

We could have an economic system that will collapse in a few years, so I think they are earnest about it, but I think that there, jawboning is not enough.

It helps and they should be encouraged to do it, but I think that they do need legislation. I am delighted to know that you folks on this committee are going to perhaps introduce legislation.

Mr. DORGAN. Has there been any evidence of any significant kind of jawboning from the Fed?

Senator PROXMIRE. Certainly not enough. I have quoted that in my first page that he spoke out, but not with enough force, and not in my view sufficiently.

Mr. DORGAN. When I talked about our responsibility to create rules for the free marketplace, what I mean is that, in the absence of a regulator, the free marketplace is not free.

The rules involve antitrust, legislation and enforcement, and dozens of other things. The free market is not something that automatically happens and remains. It requires careful attention, by those of us who are required to create rules and keep the free market free.

Senator PROXMIRE. I agree with that.

Chairman PICKLE. Senator Proxmire, we appreciate your being with us this morning, and we appreciate your testimony.

Senator Chafee.

STATEMENT OF HON. JOHN H. CHAFEE, A U.S. SENATOR FROM THE STATE OF RHODE ISLAND

Senator CHAFEE. Thank you, Mr. Chairman.

I want to thank you, Mr. Chairman, I must say, I am delighted that you are looking into this whole matter, and I am going to give an abbreviated statement.

As you know, there has been a barrage of takeovers going through the corridors of corporate America. Without a doubt, some of these takeovers redeploy underutilized assets, enhance their efficiency, and give shareholders a fairer return than they would otherwise receive.

Hostile takeovers, on the other hand, demoralize companies, disrupt local communities and pressure top executives into wasteful defensive tactics that focus on the short-term rather than a long-term future. Hostile takeovers or assaults on companies by corporate raiders, have reached epidemic proportions, leaving most corporate chiefs worried from one day to the next.

To fend off hostile assaults, U.S. corporate chiefs are purposely inflating their debt, paying billions in ransom, and squeezing even more short-term earnings out of their operations, all at a heavy cost to long-term competitiveness.

I wonder who is minding the store? CEO's are spending enormous amounts of time worrying about who is going to acquire them, who they are going to acquire in order to avoid being acquired themselves, huddling with accountants and their financiers, huddling with their lawyers.

Hostile takeovers, utilizing high-risk financial vehicles and enjoying the benefits of our tax laws, are aimed at short-term profits for professional speculators at the expense of long-term economic performance. This activity is not in the national interest.

In order to finance their recapitalizations and buyouts, management is selling assets, cutting back on capital expenditures, and cutting back on operating expenditures like research and development.

If we are to compete effectively in the future, industry must expand its investment in innovation and new technology, not forego R&D expenditures in order to satisfy speculating bounty hunters.

Countries with which we compete in the international marketplace experience few if any hostile takeovers. These very same countries have learned the effectiveness of cooperative vehicles for research and development, as the cost of conducting R&D gets even higher.

This is quite different from the kind of harmful environment in this country where raiding companies soak up scarce capital resources.

To avoid a hostile takeover, management's attention must be riveted on the short term. lest quarterly results lag; crucial invest-

ments in the firm's long-term health may be deferred or not made at all. Preparation for a possible takeover attempt involves countless hours spent studying, discussing and implementing offenses and defenses. Meanwhile, development of new products and services, or improvements in technology, process, or efficiency fail to receive the undivided attention they must. Once a hostile bid is underway, some managements employ measures that may represent costs which will take many years to recover.

The implications for our Nation's continued competitiveness, prosperity, security and quality of life demand critical response rather than acceptance of the status quo. Today's price per share is all that matters; the stock markets accommodate speculators rather than investors.

The neutrality which the Williams Act was enacted to ensure no longer exists in the market for corporate control. By adoption of the Williams Act in 1968, Congress intended to protect investors.

But a major aspect of the effort to protect the investor was to avoid favoring either management or the takeover bidder. There is a decided tilt in favor of the hostile bidder in this most recent wave of hostile takeovers.

Today, there are many explanations for this, not the least of which is found in our income tax laws. Our Government actually subsidizes hostile bids by permitting not only the full deductibility of interest on debt borrowed by a raider to finance deals, but also a stepped-up basis for writing off the target's assets with a corresponding reduction in taxes and increased cash flow. Furthermore, the tax laws may—this is not clear, but they may—allow targets to deduct the greenmail settlement payments as a business expense.

Much attention has been given to the tactics used by corporate raiders to gain control. But the defensive tactics used by management to thwart hostile takeovers also do great damage to the target company. Is it fair that corporate management has virtually unlimited discretion to use or sell corporate assets to defend against a takeover? In the case of a hostile takeover, it is clear that management's interest in perpetuating its control may conflict with the interest of the shareholders, the employees and the future of the company.

The Williams Act neutrality has been further eroded by the current operation of the securities markets themselves, and their increasing dominance by institutional investors, that principally stacks the deck for the raider. A recent SEC study estimates that institutional ownership increased from 30 percent to 38 percent between 1980 and 1983. Institutional fund managers have customary short-term horizons, and this is understandable. They are out there to make money for their customers. The narrow focus of the institutional holder also facilitates arbitragers in acquiring interests in the target. A target is thus put in play on a field owned by new shareholders, whose only interest is to see the tender offer succeed regardless of the cost. Almost inevitably, a target will "lose" such a game. In the process, whole communities, employees, suppliers, and the Nation's economic health suffer great losses as well.

Our responses to this hostile activity during the 98th Congress were reactive and piecemeal. Those proposals focused on defensive practices employed by management of target companies, thereby

ignoring the role played by raiders and their allies, the arbitrageurs.

I have introduced legislation in the Senate, the Tender Offer Reform Act of 1985, which is intended to improve the ground rules for decisionmaking by those in a position to focus on the long-range economic implications of a hostile takeover transaction. The outside directors of the target company would have the role of assessing and approving the tender offer transaction.

This proposal would also require more meaningful disclosure than currently required under our securities laws. This disclosure would give shareholders more information about the anticipated effects of a takeover on the target company's employees, creditors, suppliers, customers and the community in which it operates.

Of more concern to this subcommittee is another bill I introduced, amendments to the Internal Revenue Code to address the way present tax laws reward hostile corporate raiders.

Where the target's outside directors have rejected a bid, any ensuing takeover initiatives by a raider should not be subsidized by the Government, but should succeed or fail on its merits. Nor should our tax laws encourage management to make huge settlement payments in the form of greenmail and payment of the raider's expenses. If disinterested directors have rejected the bid, such payments would hardly be defensible under the business judgment rule, and should not be rewarded by our tax laws. These tax changes would ensure the oft-espoused Government neutrality during such a takeover battle.

There are three aspects to my tax proposal, each designed to accomplish a different objective, but all designed to stem the tide of these unproductive hostile takeover attempts. The outside directors of the target company are the ones that determine if a takeover is hostile.

First, the bill would make any so-called greenmail payments made by a corporation nondeductible for Federal tax purposes. It is my understanding that these payments should be nondeductible under current law, but some aggressive corporate tax attorneys are advising their clients that the payments are deductible, on the theory that they are made under emergency circumstances to save the corporation. I want to make it perfectly clear that they are not tax-deductible.

Second, this bill would rquire a mandatory election under section 338 of the Internal Revenue Code of 1954 in the case of hostile takeovers. Such a mandatory election would have the effect of treating the stock purchase as a purchase of the assets of the corporation, with the result that a tax would have to be paid on the gain generated. Furthermore, the bill requires that the basis of the assets acquired in the hostile takeover be reduced by the amount of the tax paid.

Finally, the bill would deny an interest deduction for debt used to finance a hostile takeover. I will admit, this is pretty tough medicine. However, I am not trying to affect the free market forces.

Mr. Chairman, this approach to hostile takeovers does not imply lack of support for free market forces. A free market economy is the foundation of our country's greatness and, as such, should proceed with minimum Government interference. I fully support the

ability of corporations to merge and the right of shareholders to replace inefficient management when necessary.

But these hostile takeovers are undermining our economic system and our competitiveness in a way what we can ill-afford. The massive debt being borne by target companies either as a result of a successful hostile takeover or to defend against one, further exacerbates the direction in which our economy is moving. Our Government faces massive budget deficits. Our trade deficits are alarming. The influx of foreign capital to finance these deficits threaten to make us the biggest debtor nation in the world. This leveraging of America is a trend we cannot responsibly ignore.

The Congress must move ahead to address the devastating effect of these corporate raids. Corporate raids have set off fear and outrage in executive suites across the country. Our role is clearly not to protect entrenched and inefficient management, but to prevent management from engaging in more short-term thinking than they are already doing. Furthermore, this Congress has a responsibility when the long-term competitiveness of our corporate sector is threatened by a trend toward high leveraging and quick profits for arbitrageurs and speculators.

I am happy that this committee is investigating this problem and analyzing the role of our tax laws in encouraging the hostile environment in the marketplace.

Thank you for the opportunity to appear before you. I am delighted you and your subcommittee are spending time on this. I commend you for it, and want to do anything I can to be helpful.

Chairman PICKLE. Senator, we appreciate your being with us this morning. You have introduced legislation specifically on this. Hearings have been set in April?

Senator CHAFEE. Yes.

Chairman PICKLE. As I understand it, your bill expressly denies any deduction for greenmail payments by a target corporation. Now, if we make these deductions or payments nondeductible, are we eliminating a defense that the targeting company might use otherwise?

Senator CHAFEE. Mr. Chairman, there is considerable doubt now whether they are deductible or not now. Some are suggesting they are, but frankly, I think these greenmail payments are terrible. I don't see why one stockholder should receive more money than the other stockholders can obtain.

Maybe we are eliminating a defense, but so be it. I think it is a defense that ought to be eliminated, and certainly, it shouldn't be deductible.

Chairman PICKLE. Does your bill provide any special rules regarding the recipient of greenmail? For example, it has been suggested that we ought to tax greenmail profits as ordinary income, to prevent long-term capital gain treatment.

Do you agree with that?

Senator CHAFEE. I have not done that, but that is a possibility that I wouldn't be averse to. I just hadn't thought of it. It would discourage these payments.

Greenmail would be defined as the difference between the market price and the extra price and that difference would be taxed as ordinary income.

Chairman PICKLE. Would you clarify for me just what you mean when you said you would request greater disclosure in one of these enterprises. In what way?

Senator CHAFEE. They have to indicate what their current plans were. Obviously, we cannot predict way in the future, but the current plans regarding closure of the headquarters, consolidation of the functions, or selling off of entities of the targeted corporation, so that the stockholders would really know what was going to happen.

We have all seen the ads in the Wall Street Journal and the New York Times of the Gulf Oil Building in Pittsburgh being for sale. I wonder if everybody knew that was going to happen when they went into that Gulf deal. Maybe they did, but certainly the purchasing corporation knew what was going to happen, and they should have told.

There should have been disclosure, to let the stockholders know what is going to happen to the extent it is known.

Chairman PICKLE. Thank you. Mr. Rangel.

Chairman RANGEL. Thank you, Senator, for sharing your views with us.

I am having a problem in determining what is friendly and what is hostile. Assuming that we had a situation where a corporation wanted to buy out another and merge, and assuming they had sound economic reasons to believe that they could provide more jobs and have a higher profit if they took advantage of existing law. They approached the victim or the smaller corporation and they were rejected out of hand by the overwhelming majority. They decided that if they got a big loan and were able to write off the interest and just target a few of the necessary stockholders that they could take advantage of a net operating loss and a variety of things in the existing code. Assuming they took over the corporation and told the new stockholders it is none of their business whether they are going to close the corporate headquarters or expand the corporate headquarters of the unfriendly, hostile corporation, that they think they got a pretty sound deal, this is based on existing law and most economists would say it is a little risky, but that is the American way to do business. Would your legislation prevent that from happening?

Senator CHAFEE. It would make it more difficult. I believe that in these situations, a takeover is considered hostile if the targeted corporation's outside directors determine that it is not in the best interest of the targeted corporation. That is what triggers the word "hostile" under my legislation.

Chairman RANGEL. What has that got to do with a sound economic objective of the so-called unfriendly corporation?

Maybe the directors have just been—dumb and they don't know what is good for them?

Senator CHAFEE. That has happened with directors. The question is, how else do we handle this?

Maybe it is not a problem in the view of some. I think it is a problem.

Chairman RANGEL. I know it is a problem.

Senator CHAFEE. And the question is how to handle it.

Chairman RANGEL. I am just giving a hypothetical where perhaps your solution might just impede the free marketplace from working. Just because we have a firm that does not want to be taken over, it doesn't necessarily mean that the unfriendly raider doesn't have a sound economic plan that would enhance recovery.

Senator CHAFEE. He can go ahead. My proposal clearly makes it more difficult—no question about that—but it doesn't make it impossible.

If they want to proceed, go ahead and proceed, but I think these disclosure items are things that the stockholders of the target corporation have a right to know.

It may make a lot of difference to the citizens of Bartlesville, OK, whether their company is going to be moved out of Bartlesville or not, whether the whole thing is going to be taken to Texas, Pennsylvania, or New York. But at least they ought to know.

Based on that, they can make an informed judgment. Maybe it is more important to them to forgo a certain amount of dollars' profit in their stock in order to have the company remain in their hometown.

I don't have any difficulty with the disclosure part.

Chairman RANGEL. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Thank you, Senator.

Your proposal also appears to give the independent director almost the power to say yes or no in this type of a merger; is that correct?

Senator CHAFEE. It gives him a lot of power. It doesn't prevent a takeover. It certainly slows them down.

Mr. SCHULZE. Suppose I want to make a semihostile takeover but I go to the independent board of directors, whereupon I say we have been doing business with your company for years, XYZ Corp. We are going to have a little sweetheart deal here, but you had better take care of my merger on this side.

It just seems to me there are all kinds of potential difficulties. What it appears you are proposing is that if this is a friendly takeover, then my tax benefits are going to be good; if it is not, they are going to be bad, which could mean millions or hundreds of millions of dollars in some instances.

An awful lot of money is involved here, and I would hesitate to allow a few individuals, who often are decided by State law as to whether or not they are independent directors to make the decision. It seems to me that we have got to look into some refining technique. Presently, you are proposing too much power to too few who probably shouldn't be in a position to have that kind of power in the first place.

Senator CHAFEE. That may be. If one of the ramifications of this is that we improve the quality of directors and make people more selective in directors, I think the Nation would be better off.

Mr. SCHULZE. If I were controlling a corporation, I would want to make sure that my independent directors would listen to me.

Management always wants to protect itself, feather its own nest. Consequently I question how independent they might be if management is at the demise of the so-called independent directors.

Senator CHAFEE. I think not.

Mr. SCHULZE. Do you believe the chairman of the board would deliberately get somebody who he thinks would go against his wishes? These independent directors could be dictating tax policy. A few people might be deciding whether or not you get the stepped up basis and the other tax questions.

Senator CHAFEE. It might make the stockholders a little more cautious of who they choose for directors. The institutional investors have a big hand in corporations, but I think they are pretty pliant as far as directors go.

As you mentioned, directors often are handmaidens of the management and it is time we got directors who are independent. Maybe this will make the stockholders take more interest in them.

Mr. SCHULZE. If I understand your legislation correctly, a taxpayer does not receive the benefit of a stepped-up basis in a hostile takeover?

Senator CHAFEE. That is correct.

Mr. SCHULZE. What happens if you don't do things just exactly the way some local politician wants you to do? For example, what happens if you don't promise to keep 400 people in that headquarters building because the Governor is going to be upset, and the Senator, and Congressman? Should policy be dictated on that basis?

Senator CHAFEE. That isn't determinant. You disclose that no matter how you proceed. I think there ought to be some disclosure as to the ramifications that these hostile takeovers are going to have.

But that is a disclosure, and based on that disclosure, stockholders make their judgment. If you are going to move the headquarters, it doesn't mean the deal is killed; it just means you have to disclose it.

Mr. SCHULZE. It sort of triggers a chain of events. If the independent directors hear all of this, then they are going to be swayed one way or another. Let's say they are promised even better directorships by the acquiring corporation. These matters concern me.

Several pieces of your legislation, as I undertand it, give me great concern. I possibly thought they should be given to other alternatives.

I thank you, Senator.

Senator CHAFEE. On the stepped up basis, you do get the basis increased, but your taxes are deducted from the stepped up basis.

Now, under present law, your basis would be increased by those taxes.

On my system, the targeted corporation would have to pay the taxes, and then the taxes paid would be deducted from the basis.

Mr. SCHULZE. The tax on the stepped up basis?

Senator CHAFEE. Yes; so there are tax consequences, no question about it.

Chairman PICKLE. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

Welcome, Senator.

I just have one question I would like to ask. Knowing that the Tax Code allows the deductibility of interest for debt, my question is this: If we perceive the problem to be significant, would it not be better in your opinion to take an across-the-board remedy, instead

of defining what is hostile and what is friendly, but just denying the total deductibility of debt interest in any merger?

In my opinion, it appears that would then make the Tax Code neutral as between debt financing and equity financing. What is your reaction to this idea?

Senator CHAFEE. Well, I think that you have got some situations, as Mr. Rangel was pointing out, in which a merger of two companies is going to make the whole greater than the parts. I don't think you want to discourage those.

It may be necessary for some debt to be incurred in order to finance this. So that I don't think I would want to go as far as abandoning the deductibility of interest entirely.

Mr. ANTHONY. If you do not take that position, then it appears to me that you are willing to have the Tax Code skewed and not neutral. You then are creating an inequitable situation, as far as the Tax Code is concerned, between equity and between debt if my analogy is correct.

Senator CHAFEE. That is right. Yes. We are saying the Tax Code is not neutral but we are saying that in certain circumstances, that is, a hostile takeover, you don't get a deduction while in others you do.

To that extent, it is not neutral. That is right.

Mr. ANTHONY. So you are saying to the subcommittees to take a hard look at the record. At the conclusion of the testimony, if we feel that the long-term public policy is good for all of the reasons that have been stated and will continue to be stated, obviously we have some opposition witnesses coming in later. We would try to, in the name of public policy, say yes, the Tax Code should be utilized but it should be treated differentially and therefore not always from a neutral standpoint.

You are saying also that the public good in other contexts would override the public good of a neutral Tax Code?

Senator CHAFEE. That is right. That is what I am saying.

I suspect testimony here has been to the effect that this is causing all kinds of difficulties in corporate America; major corporations increasing their debt, so they will be less attractive for a takeover. That is the silliest thing. That isn't the way we want to run the country.

We have been preaching how corporate America has to concentrate on the long term, not concentrating on short-term gains, being worried about each quarter's profits, in order to be able to successfully compete in the international marketplace. We want more R&D. We want companies to be innovative and plan for the long haul. All this current takeover business is causing them to do exactly the opposite.

So what are we going to do about it? We can sit by, and wring our hands, or we can take some action. I don't know whether my action is the best, but I think something should be done to slow it down.

Certainly the Tax Code shouldn't be encouraging it.

Mr. ANTHONY. I thank you for your valuable contribution, and yield back the balance of my time, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Anthony.

Senator, we appreciate your coming over here. We will look at your bill carefully along with other legislation introduced.

This committee will hold another hearing on April 16 on this same subject. This will be just a few days prior to the hearings that you will be holding in the other body.

So I hope we will stay in close touch with each other and see if we can find some approach to better control this matter.

Thank you for coming to appear as a witness.

Now we are going to ask Mr. David Brockway, chief of staff for the Joint Tax Committee, to come forward.

We are going to ask Mr. Brockway to present testimony and then at the conclusion of that, we are going to depart a bit from our schedule to hear testimony from one witness who is going to have to leave to catch an early plane.

So we are going to hear from the New York City Comptroller, Mr. Goldin, cochairman of the Council of Institutional Investors.

I understand Mr. Goldin is here, so we will be glad to hear him after we have heard from the Joint Tax Committee.

STATEMENT OF DAVID H. BROCKWAY, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Mr. BROCKWAY. In my remarks this morning, I will give a brief overview of the tax treatment of mergers and acquisitions.

Chairman PICKLE. Do you have a prepared statement?

Mr. BROCKWAY. Unfortunately, I do not at this time. I will have one available for submission for the record.

I do have the pamphlet that we have prepared for the committee, and I would hope that that could be inserted in the record.

[The information follows:]

[JOINT COMMITTEE PRINT]

FEDERAL INCOME TAX ASPECTS OF MERGERS AND ACQUISITIONS

SCHEDULED FOR HEARINGS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

AND THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

ON APRIL 1, 2, AND 16, 1985

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INTRODUCTION

The Subcommittee on Oversight of the Committee on Ways and Means, in conjunction with the Subcommittee on Select Revenue Measures, has scheduled hearings on April 1, 2, and 16, 1985, on Federal income tax aspects of corporate mergers and acquisitions. This pamphlet,* prepared in connection with the hearings, provides a description of many of the relevant Federal income tax considerations.

The first part of the pamphlet contains an overview. The second part generally discusses tax policy issues raised by the applicable and proposed tax rules. Part three describes, in simplified form, common forms of acquisition transactions, and part four contains a more detailed and technical articulation of the applicable tax rules. The fifth part discusses possible changes in some of those rules and suggests other areas that may warrant further examination. An Appendix briefly describes possible technical amendments that might be considered.

*This pamphlet may be cited as follows: Joint Committee on Taxation, *Federal Income Tax Aspects of Mergers and Acquisitions* (JCS-6-85), March 29, 1985.

I. OVERVIEW

The United States is presently in the midst of what appears to be the fourth major merger[1] wave since the turn of the century (see Table 1). Like the current merger wave, previous merger booms occurred during strong stock market upswings.[2] Merger waves are thought to be related to a variety of economic factors including stock market fluctuations, advances in production and distribution technology, and changing demand conditions. In addition, merger activity is indirectly influenced by the tax system and is directly regulated by the Federal Trade Commission, the Justice Department, the Securities and Exchange Commission, and other agencies.

Table 1.—Mergers and Acquisitions, 1968–84

[Dollar amounts in billions]

Year	Number of transactions [1]	Value of consideration exchanged [2]	
		Nominal dollars	Constant (1983) dollars
1968	4,462	43.0	112.2
1969	6,107	23.7	58.8
1970	5,152	16.4	38.6
1971	4,608	12.6	28.3
1972	4,801	16.7	36.0
1973	4,040	16.7	34.0
1974	2,861	12.5	23.4
1975	2,297	11.8	20.2
1976	2,276	20.0	32.5
1977	2,224	21.9	33.7
1978	2,106	34.2	49.0
1979	2,128	43.5	57.3
1980	1,889	44.3	53.5
1981	2,395	82.6	90.9
1982	2,346	53.8	55.9

[1] Under the Internal Revenue Code, "merger" is a term of art, referring to certain kinds of combinations of one corporation with another on a tax-free basis under section 368(a)(1)(A). In this pamphlet, the term generally (except in part four) is used in a non-technical sense to refer to any acquisition of one corporation by another.

[2] F. M. Scherer, *Industrial Market Structure and Economic Performance*, 1970. Scherer identifies 3 merger waves up to 1970: 1887-1904, 1916-1929, and the post-World War II recovery through 1970.

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Table 1.—Mergers and Acquisitions, 1968–84—Continued

[Dollar amounts in billions]

Year	Number of transactions [1]	Value of consideration exchanged [2]	
		Nominal dollars	Constant (1983) dollars
1983	2,533	73.1	73.1
1984	2,543	122.2	117.8

[1] Includes only publicly-announced transactions involving transfers of ownership of 10 percent or more of a company's assets or equity, provided that the value of the transaction is at least $500,000.

[2] Includes only those transactions for which valuation data are publicly reported.

Sources: W.T. Grimm & Company and Council of Economic Advisors.

The current upsurge of merger activity has received considerable publicity because of the unprecedented size of the corporations that have been acquired and the costly and novel defensive and offensive strategies that have been pursued in huge takeover contests. Some have expressed concern that the $122 billion spent on mergers and acquisitions last year diverted corporate resources and management attention away from more productive internal investment opportunities and management responsibilities. Others contend that the threat and conduct of takeovers is socially beneficial because management is forced to maximize the value of corporate assets or risk losing operating control. The effect of tax and regulatory policies on the market for corporate control is an issue of significant economic and political consequence: the market value of the securities issued by publicly-traded corporations accounts for over 20 percent of the nation's wealth.[3]

Certain features of the corporate and individual income tax (as well as of the estate and gift tax) may affect the attractiveness of mergers from the standpoint of both the acquiring and target corporations and their shareholders. The tax Code may be harmful to economic growth if tax considerations encourage inefficient, or discourage efficient, changes in the ownership of corporations or their assets.

[3] *Annual Report of the Council of Economic Advisers* (February 1985).

II. TAX POLICY AND THE MARKET FOR CORPORATE CONTROL

The tax Code influences corporate acquisitions directly through rules governing the sale or other disposition of corporate stock or assets and indirectly through the general rules pertaining to the taxation of corporate and individual income and of estates. The interaction of these tax rules may affect the number of acquisitions, the form of an acquisition, the type and amount of consideration paid, the tactics used in takeover contests, and the corporations that are candidates for becoming acquirors or targets. The organization of this part is as follows: first, the relevant tax rules are summarized; second, the effect of those rules on the form and substance of merger activity is analyzed; third, the policy implications of tax-motivated merger activity are assessed; and fourth, some general proposals for change are evaluated.

A. Summary of Tax Rules

Three features of the Federal income tax appear to have the most significant effect on the pattern of merger activity: (1) the differing tax consequences of acquiring an entire corporation versus acquiring individual corporate assets; (2) the disparate treatment of various forms of corporate "distributions" resulting made in the form of interest, dividends, and long-term capital gains; and (3) the inability of corporations with limited taxable income to take full advantage of business tax preferences. These and other aspects of the tax rules are described below.

1. General provisions of the corporate income tax

Income from corporate assets that is paid to debtholders is not subject to tax at the corporate borrower level since interest payments generally are deductible for purposes of computing taxable income. Conversely, corporate income paid out as dividends is subject to corporate level tax since dividend payments are not deductible by a corporation. Thus, the combined individual and corporate tax on debt-financed investment is no more than 50 percent (the top individual rate), while the combined tax on income distributed from equity-financed investment is as high as 73 percent (assuming a 46-percent corporate rate).[4] As a result, the after-tax return on a dollar of income on debt-financed assets (50 cents) is, at the highest tax rates, almost double the return on a dollar from equity-financed investment (27 cents). A company with a high debt-to-equity ratio may have a tax advantage over a similar company with little debt financing. Debt-financed acquisitions effectively in-

[4] In this case, $100 of corporate income is subject to $46 of corporate income tax, and the remaining $54 of after-tax corporate income is subject to up to $27 of tax at the shareholder level when distributed. The maximum combined tax is $73 ($46 plus $27).

crease the debt-to-equity ratio of the acquired corporation and thus may increase share price to the extent that the tax advantages of debt financing are not outweighed by the disadvantages (e.g., increased bankruptcy risk).

Under current law, a substantial percentage of the economic income of corporations escapes corporate income tax as a result of various tax preferences provided by the Code. Examples of these preferences include the investment tax credit and accelerated depreciation. These preferences cannot be used on a current basis by corporations that do not have sufficient taxable income in the current or prior 3 years. Such corporations can carry forward (up to 15 years) net operating losses and excess credits until current taxable income is sufficient to absorb them.[5] Companies in a carryforward position are often at a tax disadvantage relative to companies that have sufficient taxable income to use available tax preferences currently.[6] Thus, there is a tax incentive for structuring mergers which effectively permit more rapid utilization of current preferences and carryforwards.[7]

2. General provisions of the individual income tax

Shareholders are taxed on the income from corporate assets only when distributed as a dividend or when gain is realized from a sale or other disposition of their shares. Thus, shareholders can defer tax on corporate income that is reinvested rather than distributed as a dividend. This may result in large accumulations of undistributed corporate income and attract takeover attempts.[8] If reinvestment opportunities are limited, management may decide to use retained income to acquire control of another corporation, lest their own corporation be subject to a similar fate. Alternatively, retained earnings might be used by the corporation to redeem, or repurchase, its own shares; however, management may prefer to expand the size of the corporation through acquisition rather than shrink it through redemptions of shares.

Individual shareholders are taxed at ordinary income rates, of up to 50 percent, on dividends paid out of corporate earnings. However, individuals are taxed on only 40 percent of capital gains from the sale or other disposition of stock (as a result of the 60 percent capital gain deduction). Consequently, the effective rate of tax on capital gains of individuals is no more than 20 percent. Further, because of the stepup in basis of property at death, some gain is not taxed at all. Thus, the Code creates an incentive for corporate transactions and financial policies that produce capital gains, whether currently taxable or deferred, rather than dividends for individual shareholders.

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[5] A corporation experiencing a real economic loss might have NOL and foreign tax credit carryovers even in the absence of tax preferences. However, the prevalence of corporate tax preferences greatly increases the likelihood that even a profitable corporation will be in a carryforward position.

[6] Corporations may seek to absorb their NOLs by the sale and leaseback of their assets, by recognizing built-in gains, or by other transactions. However, these transactions may be costly or unavailable.

[7] Use of NOLs, excess credits, and built-in losses following an acquisition is limited by Code sections 382, 383, and 269, among others, and by the consolidated return regulations.

[8] Section 531 (relating to unreasonable accumulations) and other sections seek to limit the accumulation of corporate earnings.

3. General provisions of the estate and gift tax

Federal estate tax generally applies to the transfer of property at death. In general, the estate tax applies equally to transfers of shares in closely- and widely-held corporations, although, in practice, there are differences. First, the valuation of shares in a closely-held corporation is less certain, so that the amount of estate tax that will be assessed by the Internal Revenue Service is more difficult to predict. Second, shares in closely-held corporations are less liquid. This may make it difficult for the executors to dispose of stock in order to pay estate taxes and other expenses. These considerations may lead a shareholder in a small corporation to exchange his shares, in a tax-free reorganization, for shares in a publicly-traded corporation. However, the Code does contain a number of provisions which mitigate the estate-tax disadvantages of holding shares in closely-held corporations and, as a consequence, reduce the incentive to merge solely for estate tax purposes.[9]

4. Income tax treatment of acquisitions

The Code distinguishes among the taxable purchase of corporate stock, the taxable purchase of corporate assets, and tax-free reorganizations for income tax purposes (see Table 2). The applicable tax rules have been criticized on the grounds that economically similar acquisition transactions have different Federal tax consequences depending on their legal form.

Control of a corporation's assets can be obtained either by acquiring the assets of the target corporation or by acquiring its stock from the target's shareholders. Generally, the sale of assets by a corporation in a taxable transaction results in the recognition of gain (or loss) to the seller. In addition, the buyer uses its cost for the assets for the purpose of subsequent depreciation, depletion, and amortization deductions and gain or loss computations.

On the other hand, the purchase of a corporation's assets and its subsequent liquidation pursuant to a plan of complete liquidation under section 337 generally does not trigger corporate recognition of gain (although there are exceptions for recapture and similar items) or loss.[10] Even though gain is not generally recognized, the purchaser will step-up the basis of the assets to their cost. A similar result is obtained by a purchase of shares followed by a section 338 election. If there is such an election, the target generally is treated as having sold its assets in a section 337 transaction.

Alternatively, the purchase of the stock of a corporation may avoid gain recognition (including recapture) by that corporation if a "carryover" transaction is chosen. In a carryover transaction, the acquired corporation retains its tax attributes (such as net operating loss carryovers, credit carryovers and asset basis). Corporate-

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[9] Section 6161(a)(2) provides for an extension in the payment of estate tax under certain conditions. See also section 6166. Section 303 provides exchange rather than dividend treatment for redemptions of certain stock included in an estate in an amount up to the amount of estate taxes and administrative expenses. In addition, the Economic Recovery Tax Act of 1981 liberalized the estate and gift tax. See Alan L. Feld, *Tax Policy and Corporate Concentration* (1982), pp. 97-99.

[10] Section 337 is an extension of the "codification" of *General Utilities and Operating Co. v. Helvering*, 296 U.S. 200 (1935), in section 336. *General Utilities* is often cited for the proposition that, absent a Code section to the contrary, a corporation recognizes no gain or loss when property is distributed to shareholders.

level carryover tax treatment is accorded in tax-free reorganizations and in taxable stock acquisitions where a section 338 election is not made or deemed made. Determining whether carryover or step-up tax treatment is more favorable requires considerable analysis, and the acquirer in a taxable stock acquisition frequently will take advantage of the time allowed by section 338(g)(1) before making a section 338 election.[11]

Table 2.—Income Tax Treatment of Corporate Acquisitions

Tax consequence	Taxable asset acquisition without complete liquidation	Taxable stock acquisition with sec. 338 election [1]	Taxable stock acquisition without sec. 338 election	Tax-free reorganization
Corporate income tax				
Recognition of gain/loss.	Yes	No	Deferred	Deferred.
Recapture	Yes	Yes	Deferred	Deferred.
Revaluation of basis.	Yes	Yes	Deferred	Deferred.
Transfer of NOLs[2].	No	No	Yes[3]	Yes.[3]
Individual income tax				
Recognition of gain/loss on exchange of shares for:				
1. Cash	N.A.	Yes	Yes	Yes.
2. Debt	N.A.	Deferred	Deferred	Varies.
3. Stock	N.A.	Yes	Yes	Deferred

[1] The same tax results generally flow from a liquidating sale under section 337.
[2] Similar tax treatment applies to credit carryovers and built-in losses.
[3] Use of NOL and credit carryovers and built-in losses is limited by sections 382, 383, and 269, among others, and by the consolidated return rules.

The tax consequences of a corporate acquisition at the shareholder level hinge on whether the acquisition is structured as a tax-free reorganization and on the type of consideration received. In qualified reorganizations, shareholders of the target corporation are not taxed currently if they exchange their stock or securities solely for stock or securities in the acquiring corporation.[12] By contrast, in

[11] Under Treas. temp. regs. sec. 5f.338-1(c), a section 338 election need not be made before 60 days after publication of the next set of temporary regulations under section 338.
[12] The Code provides rules governing 6 generic types of corporate reorganizations which qualify for tax-free treatment: (A) statutory mergers; (B) acquisitions of stock for stock; (C) acquisitions of property for stock; (D) transfer of assets to controlled corporations; (E) recapitalizations;

Continued

taxable stock acquisitions and liquidating sale transactions, shareholders of the target corporation are generally taxed currently even if they receive stock in exchange for their shares (as if their shares had been sold).

Under the installment sale rules, where target corporation shareholders exchange their shares for non-readily tradable term debt of the acquiring company in a tax-free reorganization, taxable stock acquisition, or liquidating sale transaction, the recognition of gain generally may be deferred until principal payments on the note are received. (sec. 453). If the acquiring corporation makes a section 338 election in a taxable stock acquisition, then basis in the acquired assets is revalued at the date of election taking into account on the principal amount of the note, even though the target's shareholders recognize gain only as principle is amortized. In this manner, the buyer can step up basis while the target corporation wholly escapes tax on gain and its shareholders defer tax on gain.

In summary, the tax treatment of economically similar acquisition transactions depends on the legal form of the transaction. Rather than sell its appreciated property, or distribute its assets retained earnings directly to shareholders, a corporation may achieve more favorable tax results in a properly structured acquisition. Thus, the decision to execute a corporate acquisition, and the decision to structure the acquisition in a particular legal form, are both influenced by tax considerations.

B. Effect of Tax Rules on Merger Activity

Although mergers are often motivated by factors other than tax, Federal tax rules do create a number of opportunities for using mergers as tax planning devices. In this section, four tax planning strategies involving the use of mergers are identified: (1) merger as a means of distributing corporate assets ("distributive" merger): (2) merger as a means of churning the tax benefits on depreciable assets ("churning" merger); (3) merger as a means of increasing debt financing ("leveraged" merger); and (4) merger as a means of transferring tax benefits ("tax benefit transfer" merger). In addition, tax barriers to merger (i.e., situations where the tax rules may inhibit merger) are also discussed.

1. Distributive mergers

The Federal income tax rules generally conform to the principle that earnings and gain are taxed both at the corporate level and the shareholder level to the extent received or accrued. However, in certain types of mergers and acquisitions, it is possible to structure transactions so as to escape, defer, or reduce the rate of taxation at both the corporate and shareholder levels.

The consequences of the tax rules can be illustrated by means of two simplified examples involving a corporation with $100 of retained earnings, in the first case, and $100 of built-in (unrealized) gain, in the second case. In both cases, the corporation has a $10 basis in nondepreciable assets (e.g., land) originally purchased for

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and (F) mere changes in identity, form, or place of organization. (See also section 368(a)(1)(G), which relates to reorganizations involving certain financially-troubled companies).

$10, and there are no deductions or credits that are subject to recapture. In both cases the market value of the corporate assets is $110—$10 of basis plus $100 of retentions or built-in gain, respectively. The corporation is subject to tax at a 46-percent rate on ordinary income and at a 28-percent rate on capital gain. Shareholders, who have a $10 total basis in their stock, are subject to tax at a 50 percent rate on ordinary income and at a 20 percent rate on capital gains.

In the first case, the shareholders wish to realize the $100 of corporate retained earnings (on which the corporation may or may not have paid taxes). If the corporation distributes a $100 dividend, shareholders will be liable for $50 of income tax (see Table 3). Alternatively, the shareholders might sell their stock for $110 in cash to an acquiring corporation in a taxable stock acquisition or have the corporation do a liquidating sale under secton 337. Either case would result in $20 of capital gains tax liability for the shareholders, on their $100 in gain, and no corporate tax. Finally, the shareholders might exchange their shares for $110 worth of stock in an acquiring corporation pursuant to a qualified reorganization. In that case, the shareholders would take a substituted basis in the stock received from the acquiring corporation and defer tax on their gain (perhaps forever). Thus, as shown in Table 3, the "distribution" of $100 of corporate income can have tax results ranging from $20 of deferred tax liability to $50 of current tax liability, depending on the form of the transaction.

Table 3.—Tax on the Realization of $100 of Retained Earnings

Tax	Non-liquidating distribution	Taxable stock acquisition with sec. 338 election [1]	Taxable stock acquisition without sec. 338 election	Tax-free reorganization
Corporate tax	0	0	0	0
Shareholder tax	$50	$20	$20	[2] $20
Total tax	50	20	20	20

[1] The same tax results generally flow from a liquidating sale under section 337.
[2] Tax is deferred until sale of shares and will be fully forgiven if the stockholder dies before disposing of them.

In the second case, the shareholders wish to realize the $100 appreciation in corporate assets. The corporation could simply sell the appreciated asset and distribute the net after-tax proceeds to the shareholders in an ordinary distribution. If the transaction was not structured as a complete liquidation under section 337[13], then the appreciation would be taxed at both the corporate and shareholder levels. In that event, the sale would trigger $28 of corporate

[13] This would be the case if the $100 of appreciation were distributed and later, in an unrelated transaction, a $10 liquidating distribution were made.

tax (assuming the asset was a long-term capital asset), and the distributions would total $82 ($110 less $28), of which $10 would be a return of basis to the shareholders and $72 would be a nonliquidating distribution. The shareholders would be liable for $36 of tax on the nonliquidating distribution, so the total corporate and shareholder tax would be $64 (see Table 4). Alternatively, if the assets were sold pursuant to a plan of complete liquidation, corporate tax would be escaped (under the *General Utilities* doctrine and sec. 337), and the only tax would be $20 on the shareholders' $100 gain. The same tax consequences would flow from a $110 taxable stock acquisition subject to a section 338 election. However, if a section 338 election were not made, then the acquiring corporation might be willing to pay only $82 for the target's shares, because the acquirer eventually will be liable for $28 of gains tax when the asset is sold. Under these assumptions, the shareholders would recognize $72 of gain ($82 less $10) and incur current tax liablity of $14.40 (.20 times $72). Finally, the same tax consequences would flow from an exchange of shares worth $82 in a tax-free reorganization except that the target's shareholders could defer recognition of their gain.

Table 4.—Tax on the Realization of $100 of Appreciation

Tax	Taxable asset acquisition without complete liquidation	Taxable stock acquisition with sec. 338 election [1]	Taxable stock acquisition without sec. 338 election	Tax-free reorganization
Corporate tax	$28	0	[2] $28.00	[2] $28.00
Shareholder tax	36	$20	14.40	[3] 14.40
Total tax	64	20	42.40	42.40

[1] The same results generally would flow from a liquidating sale under section 337.

[2] Corporate tax is deferred until gain in assets is realized.

[3] Shareholder tax is deferred until shares are sold or forgiven if the shareholder dies holding them.

These examples show that the *General Utilities* doctrine, sections 337 and 338, and the tax-free reorganization rules create opportunities whereby shareholders can realize corporate earnings and built-in gains with less than full current taxation at both the corporate and shareholder levels.

2. Churning mergers

The Code also provides some incentive for mergers designed to minimize tax on corporate assets by churning, i.e., selling property when most of its cost has been recovered through depreciation deductions. In a liquidating sale pursuant to section 337 (or in a taxable stock acquisition pursuant to a section 338 election), the buyer

steps up the depreciable basis of acquired property to cost and the seller may be subject to recapture tax but not tax on other gain. For example, in the case of section 1250 property, there will in many cases be no recapture tax liability. Thus, if a target corporation that holds fully-depreciated section 1250 property is acquired in a transaction qualifying for step-up treatment, then the buyer will obtain a fresh depreciable basis, often with no tax to the seller. In this manner, the tax benefits of ACRS straight-line depreciation for real property can be magnified by the repeated churning of corporate assets. The benefits of churning can also be obtained by nonliquidating sales of assets. However, the Code favors section 337 and section 338 transactions because they frequently allow the seller to escape tax on gain.

3. Leveraged mergers

The preceding analysis has shown that mergers can be used to distribute assets from corporate solution and to churn the tax benefits of assets. A third tax-advantaged use of mergers is to increase the amount of debt in a target's financial structure ("leverage").

The advantages of debt financing can be illustrated by comparing 2 corporations with $1,000 of assets that are identical except for financial structure: the first is entirely equity financed; while the second is 50 percent debt financed. Both corporations earn $200 of operating income. The all-equity corporation pays $92 in corporate tax and retains or distributes $108 of after-tax income ($200 less $92). Thus, as shown in Table 5, the return on equity is 10.8 percent ($108 divided by $1,000).

Table 5.—Effect of Debt Financing on Stock Yield

Item	All-equity corporation	50-percent debt-financed corporation
Balance sheet		
Total assets	$1,000	$1,000.00
Debt	0	500.00
Shareholders' equity	1,000	500.00
Income statement		
Operating income	200	200.00
Interest expense	0	70.00
Taxable income	200	130.00
Income tax	92	59.80
Income often corporate tax	108	70.20
Return on equity[1] (percent)	10.8	14.04

[1] Return on equity is computed as income after corporate tax divided by shareholders' equity.

As indicated, the leveraged corporation is financed by $500 of debt and $500 of stock. If the interest rate is 14 percent, then interest expense is $70 (.14 times $500). Taxable income is $130 after deducting interest expense. The leveraged corporation is liable for $59.80 in corporate tax (.46 times $130) and distributes or retains

$70.20 of after-tax income ($130 less $59.80). Consequently, the return on equity is 14.04 percent ($70.20 divided by $500). Thus, as shown in Table 5, increasing the debt ratio from zero to 50 percent increases the rate of return on equity from 10.8 to 14.04 percent.[13a]

In summary, the Code encourages leveraged acquisitions to the extent that the managers of target corporations fail to exploit the tax advantages of debt financing. This may occur where managers are more adverse to bankruptcy risk than shareholders because, for example, their careers are jeopardized by bankruptcy. The Code also encourages the use of debt as payment in exchange for target stock because shareholders may use the installment method of reporting to defer capital gains tax.

4. Tax benefit transfer mergers

Generally, the Code prohibits the direct sale of tax benefits from one corporation to another, requiring instead that tax benefits reduce the tax liability of the corporation that generated the benefit. For example, deductions for net operating and built-in losses cannot be sold. Nor can excess tax credits. However, in certain circumstances, tax benefits can be acquired indirectly by means of a properly structured merger. Section 269 seeks to discourage mergers designed principally for tax purposes. In addition, sections 382 and 383 and the consolidated return rules generally seek to prevent buyers from using the target's tax benefits to reduce tax liability from unrelated assets. Nevertheless, there are a number of techniques which may allow an acquiring corporation to use a target's tax benefits more rapidly than the target.[14]

5. Other tax-motivated mergers

The preceding analysis has concentrated on the use of mergers in executing tax planning strategies designed to distribute corporate income, churn tax benefits, increase debt financing, and transfer tax benefits. Tax-motivated mergers may also occur in other situations. For example, tax-free reorganizations are a useful device in estate-tax planning for avoiding the illiquidity and valuation problems associated with stock in a closely-held corporation.

6. Tax barriers to merger

While there are many cases in which the Code appears to encourage mergers, there are also instances where the Code inhibits the combination of assets. The Code serves as a barrier to merger where shareholders in a potential target hold stock with substantial appreciation and the merger is not structured as a tax-free reorganization. In this case, the exchange of stock in the target for cash or stock in the acquiring corporation will trigger tax on the gain built into the target stock. An otherwise economically efficient combination of assets might not take place because of adverse tax consequences. Thus, the Code may contribute to economic ineffi-

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[13a] More generally, the return on equity rises with increasing debt capitalization so long as the interest rate is less than the pre-tax rate of return on corporate assets.

[14] For example, a company with net operating losses can acquire a profitable company and use its losses to reduce the target's tax liability. Similarly, a profitable company may acquire a target's NOLs in a qualified stock reorganization and subsequently transfer some of its income-generating assets to the target in an attempt to avoid the consolidated return rules.

ciency not only by encouraging inefficient mergers but also by discouraging efficient asset combinations.

C. Policy Implications of Tax-Motivated Merger Activity

The principal tax policy issues raised by tax-motivated mergers appear to be: (1) whether the effect of the tax Code on the volume and type of merger activity is harmful; and (2) whether the tax Code should be used to encourage or discourage certain types of merger or merger tactics.

Although there is little conclusive evidence, a number of experts have concluded that the Code has tended to increase the volume of merger activity. In one study, tax considerations were found to be the major reason for over one-fourth of the mergers during the period 1940-47.[15] This finding may be cause for concern because, from the standpoint of economic efficiency, mergers undertaken for tax reasons may not be justified.

Some have argued that the efficiency gains from the current merger wave are likely to be large based on studies showing that stock prices increase substantially after merger.[16] However, it is possible that a large portion of the stock price gain is in fact due to the capitalization of tax benefits arising from the merger. Obviously, if tax benefits explain the increase in stock price, then it cannot be concluded, from this evidence alone, that mergers increase efficiency. Also, the stock market gains associated with mergers appear to be ephemeral—disappearing altogether in the year after acquisition.[17]

While acknowledging that the economy would be better off without certain tax-motivated mergers, it has been argued that mergers used as a means of selling tax attributes, such as net operating losses and excess credits, may be beneficial.[18] The argument is that firms are more willing to undertake risky investments knowing that in the event of failure, some portion of loss and credit carryovers can be sold in a merger. However, after an investment has failed, there is generally no efficiency rationale for mergers designed to traffic in losses. Furthermore, the use of mergers to transfer tax benefits is a cumbersome and costly approach.

Others contend that, in the absence of evidence demonstrating that mergers are generally beneficial to the economy, tax policy should be "neutral" with respect to mergers and acquisitions. Mergers would in this case be based more on efficiency considerations (provided that antitrust enforcement is effective in preventing mergers that would create monopoly power) and more likely to increase productivity. However, in altering the tax Code to remove incentives for merger, caution would need to be exercised in order to avoid creating excessive tax barriers to mergers. Forcing recognition of gain in certain corporate acquisitions could result in a

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[15] J. Keith Butters, John Lintner, and William L. Cary, "Effects of Taxation: Corporate Mergers," Harvard Business School (1951).

[16] See *Annual Report of the Council of Economic Advisors*, (February 1985), Chapter 6. These studies compare the market value of the resulting company with the pre-merger value of both the acquiror and the target.

[17] See Warren A. Law, "Testimony before the House Committee on Energy and Commerce Subcommittee on Telecommunications, Consumer Protection, and Finance" (March 12, 1985).

[18] *Annual Report of the Council of Economic Advisors*, (February 1985).

"lock-in" effect: sale of corporate assets to superior management might be discouraged by the triggering of adverse tax results.

In addition to being concerned about the high volume of merger activity in recent years, some believe that offensive and defensive tactics employed in takeover contests are harmful to shareholder interests and public policy goals. Bidders have been criticized for, among other things, the use of "two-tier" tender offers and the issuance of sub-investment grade ("junk") bonds, while defenders have been accused of using abusive tactics such as limited share repurchases ("greenmail") and lavish severance contracts triggered by takeover ("golden parachutes"). Those who believe mergers are disruptive, inefficient, or monopolistic tend to oppose the aggressive tactics used by bidders, while those who believe that mergers promote competition and efficient utilization of resources are more worried about tactics used to ward off a hostile takeover.

The tax Code appears neither to directly encourage nor discourage such techniques as the use of two-tier tender offers or greenmail in hostile takeover attempts. The Code encourages debt-financed mergers as a result of the general tax advantage available to the debt financing of corporations and the installment method of reporting gain on shares exchanged for debt. However, section 279 seeks to discourage mergers financed by convertible subordinated debentures, although the scope of this provision is narrow. Finally, the attractiveness of golden parachutes was reduced by the Deficit Reduction Act of 1984.

While the harmfulness of certain takeover tactics is a controversial issue, there are a number of possible remedies other than tax Code amendments. If it deemed it proper, Congress could amend the securities laws to regulate certain takeover tactics. In addition, shareholders can amend corporate charters to prevent management from engaging in defensive tactics that might reduce their chance to benefit from a generous tender offer. Shareholders can also challenge defensive strategies that are not in their interest through the courts.

D. Proposals for Change

Tax-motivated mergers result from both the general rules of the Code regarding the measurement of income from capital as well as specific provisions regarding the taxation of acquisitions. Some have argued that the difficulties in accurately defining income from capital (e.g., depreciation, adjustment of basis for inflation, and recognition of unrealized capital gains) are so severe that a system which attempts to tax such income will inevitably create distortions such as tax-motivated mergers.[19] On these grounds, it has been argued that the only complete solution is to replace the current income tax with a consumption tax, such as the cashflow tax described by the Treasury Department in a 1977 study or a European style value-added tax.[20]

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[19] See for example, Avinash Dixit, "Tax Reform as Industrial Policy," Princeton University, (December 1984).

[20] Dept. of the Treasury, *Blueprints for Basic Tax Reform*, (January 17, 1977). A related proposal is discussed in Robert Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax*, (1983).

The Treasury Department's recent tax reform proposal examines these issues in great detail. The Treasury proposal rejects adoption of a consumption tax and, instead, recommends comprehensive changes in the income tax which would, *inter alia*, more accurately measure income (especially during periods of high inflation), relieve double taxation of dividends, and eliminate tax preferences.[21] These provisions would greatly limit the usefulness of mergers as a tax planning device for distributing corporate income, churning depreciable property, increasing debt financing, and transferring tax benefits.

A substantial reduction in mergers motivated, at least in part, by tax considerations might also be achieved by a reform of the income tax provisions specifically relating to mergers. A proposal to reform the taxation of corporations, published by the Senate Finance Committee staff in 1983, contains a number of provisions which might reduce tax incentives for mergers.[22] The most significant of these, in an acquisition context, are the repeal of the *General Utilities* doctrine and related rules and the imposition of new limitations on the use of loss and credit carryovers by an acquiring corporation. Specifically, this proposal would likely reduce the use of mergers as devices for distributing corporate income and transferring tax benefits. However, the proposals would not affect the use of mergers to increase debt financing. The proposals would also provide elective carryover treatment to avoid creating a "lock-in" effect that might discourage economically sound mergers. It would also generally provide nonrecognition treatment for the receipt of stock by any target shareholder as a part of an acquisition.

Congress has, in the past, considered proposals to relieve or eliminate the double taxation of corporate dividends. Complete corporate integration, such as the proposal discussed in the the 1977 Treasury Study, could eliminate many tax-motivated mergers. In Western Europe, where merger and acquisition activity is a small fraction of that in the U.S., most countries provide substantial relief from double taxation.

A more limited proposal would be to repeal the installment method of reporting (sec. 453), which allows the deferral of tax on gain when shareholders in the target exchange their stock for readily nontradable term debt. The recognition of gain might be required to the extent that the buyer takes a step-up in basis.

Recently, bills have been introduced which would deny interest deductions on a broader class of debt incurred to finance the acquisition of corporate stock or assets and impose tax penalties on payments of certain targeted share repurchases ("greenmail"). While these proposals address the most glaring symptoms of the current merger boom, they do not directly address a number of the root causes of tax-motivated mergers. This raises the question of whether tax-motivated merger activity would be reduced or, instead, alternative strategies devised for completing corporate acquisitions. For example, any "junk" bond rule might be fairly easily avoided.

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[21] Dept. of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, 3 vols., (November 1984).

[22] Staff of the Senate Committee on Finance, *Tax Reform and Simplification of the Income Taxation of Corporations*, S. Prt. 98-95, 98th Cong., 1st Sess., (September 22, 1983).

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In conclusion, proposais for change range from comprehensive tax reform to legislation designed to discourage specific takeover tactics. (See generally part five.)

III. THE ACQUISITION TRANSACTION SIMPLFIED: THE FEDERAL INCOME TAX PERSPECTIVE

This part describes the tax profiles of various potential acquired corporations and various potential acquiring corporations or groups. It then indicates particular acquisition transactions that would appear to be the most beneficial to the parties from a Federal income tax standpoint under present Code rules. The objective of this part is to inform the reader who is not an expert in the intricacies of subchapter C of the Code of (1) some of the tax benefits available in an acquisitions context, and (2) techniques authorized by the Code to obtain those benefits. Therefore, the cases described (which are not all-inclusive) are simplified cases, designed more to present general principles than to identify actual transactions. Part four contains a more technical exposition of many of the tax rules involved.

It is not intended to suggest that factors other than tax factors play no role in determining whether an acquisition is undertaken and, if so, in what form. Business, antitrust, regulatory, and other legal and personal concerns, among other considerations, are frequently as important, if not more important, than tax matters. On the other hand, it is clear that tax considerations are very relevant in many acquisitions. Furthermore, if they are not the primary reason for an acquisition, they frequently affect the price at which it is carried out although there are instances in which the availability of tax benefits is uncertain. In such a case, the buyer will generally not pay much for them. To the extent they turn out to be available, the buyer will have obtained a windfall.

One additional preliminary comment: section 269 of the Code deals with certain acquisitions the principal purpose of which is the evasion or avoidance of Federal income tax. Where 269 applies, the general effect is to prohibit the evasion or avoidance aimed at. In what follows, it is assumed in every case, without inference, that section 269 would not be applicable.

Case (1): Redemptions (share repurchases) with borrowed funds

Corporation M is a widely-held public company with little outstanding debt. It pays substantial taxes but still throws off significant cash flow. It may or may not pay large dividends to its shareholders.

From a tax standpoint, M should seriously consider borrowing a large sum of money and using the proceeds to redeem M stock held by some of its shareholders. There would be 2 significant tax advantages to such a strategy that would not be available under a "business-as-usual" approach.

First, the transaction could be structured so that any gain of the redeemed shareholders attributable to the distribution would be capital gain. In contrast, periodic distributions made by M to its

shareholders would generally be fully taxed to them at ordinary income rates as dividends.

Second, M could deduct the interest it pays or accrues on the borrowed funds. This would enable M to reduce its taxable income, perhaps to an amount approximating zero. If so, its Federal income tax liability would go down, and its cash flow could increase significantly. That increased cash flow might be sufficient to enable M to cover most of its debt service obligations with respect to the borrowed funds and retire much of the debt over a period of years (although M might also sell some of its assets to raise cash to assist it to pay off the loan). In substance, non-redeemed (i.e., continuing) shareholders would have acquired the stock of the redeemed shareholders substantially with pre-tax income. In contrast, had M not borrowed money to do the redemption, but used its own funds, the redemption would have been financed by M with after-tax income.

Thus, assume that M has 10 shares outstanding valued on the New York Stock Exchange at $100 each for a total of $1,000. The corporation has no debt, and its taxable income is $200. At a 46 percent tax rate, it pays taxes of $92.00, leaving it with a cash flow of $108.00. This is $10.80, or 10.8 percent, per share. It may or may not use all or part of that $108.00 to pay dividends to its shareholders.

Suppose M borrows $500 at 14 percent interest and uses the proceeds to redeem one-half (5) of its shares. After this transaction, it will have taxable income of $200 less $70 (interest expense), or $130. At a 46 percent tax rate, it will pay $59.80 in taxes, leaving it with a cash flow (before paying back any principal on the loan) of $70.20. That is $16.20 more than the pre-redemption 10.8 percent times the 5 shares still outstanding ($70.20 less $54.00). By servicing part of its capital with tax deductible amounts, the corporation will have increased its per share cash flow and, therefore, its per share value.

Case (2): Leveraged buy-out

If M does not proceed as suggested in Case (1) or a similar fashion, others may be willing to provide "assistance". Thus a group of wealthy individuals, including some M management, may want to buy M in a "leveraged buy-out". They are prepared to contribute 20 percent of the purchase price as equity and have made arrangements to borrow the remaining 80 percent. The buying group will use Corporation MM, a newly-created company, as the acquiring vehicle. MM will buy all the stock of M in a taxable transaction. Immediately after the acquisition, M will merge into MM. The lenders in the transaction will lend the 80 percent to MM. Immediately after MM's merger into M, the loan will be secured by mortgages on and pledges of M's former assets now held by MM. Because of the interest deductions generated by the borrowing, MM, after the merger, may have little, if any, taxable income. As a result, MM may be able to service its debt obligations out of a cash flow not reduced (or reduced less) by taxes. The buyers hope and expect that the loan (principal and interest) can be mostly paid off after several years out of that cash flow of MM. If so, M would have been acquired largely with its own pre-tax income.

Case (3): Change in shareholder investment without current tax; step-up at death

Corporation A's assets have a value approximating their tax basis. A, an operating service company, has no significant net operating loss carryovers or other tax attributes. A has a single shareholder, individual X. X, age 75, has a very low basis in his A stock. Corporation B wants to acquire A.

From a tax standpoint, the sensible deal would be for B to buy A's assets for cash (perhaps raised through borrowing) or for B and A to combine in a tax-free reorganization (with X receiving B stock in exchange for his A stock). If B bought A's assets for cash and X kept A alive as a personal holding company, A would pay minimal tax and X would pay none. Through this personal holding company, X could then make portfolio stock investments and receive (after A paid taxes on its investment income) close to a market-rate return on an amount equal to the value of A. Thus, A would have significantly changed the nature of his holding, from an operating service company to a portfolio investment company, without being currently taxed on the gain in his stock. (Furthermore, after X's death, his heirs would inherit his A stock and take a fair market value basis in it under section 1014. As a result, the appreciation in value of the A stock in X's hand might go untaxed forever.)

If B and A did a tax-free reorganization, with X receiving B stock, neither A nor X would be taxed. (Again, upon X's death, his heirs would take a fair market value in his B stock, and no tax would ever have been imposed on the appreciation in X's stock.)

If, instead, B bought the A assets and A was then liquidated, or if B bought the stock of A from X, X could use the liquidation or sales proceeds to invest in portfolio stocks. In either such case, however, X would be taxed on the appreciation in the value of his A stock.

Case (4): Step-up in basis with no corporate tax; tax-exempt shareholders

Corporation C's assets have a very low basis relative to their value. However, they have no depreciation or other recapture potential. C has no significant net operating loss carryovers or other tax attributes. C's sole shareholder, individual Y, has a basis in his C stock approximating its value. Corporation D wants to acquire C.

From a tax standpoint, a sensible deal would be for D to buy C's assets for cash (perhaps raised through borrowing). If D buys C's assets, C should liquidate under section 337. Alternatively, D could buy all Y's stock in C and make a section 338 election. (If D makes a section 338 election, the transaction would generally be treated by C as a sale of assets followed by a prompt liquidation under section 337.) In either case, Y would have only nominal tax liability, and C, under section 337, would have no tax liability at all with respect to the appreciation in value of its assets. Furthermore, D would take a "stepped up" tax basis in C's old assets equal to their cost (and thus, for example, generally could begin depreciating them immediately under ACRS to the extent they were depreciable property). As a result, the appreciation in the value of C's assets would never be taxed to any corporation. In contrast, if there were

no acquisition of C, C generally would in the normal course of its business pay tax on the appreciation in the value of its assets, and any distributions it made to Y generally would be taxed to Y as dividend income.[23]

If the parties did a tax-free reorganization, neither C nor Y would have any immediate tax liability, but D would inherit C's low asset basis and depreciation methods.

Case (5): Deferral of shareholder gain with installment sale

The facts are the same as in Case (4) except that individual Y has a low basis in his C stock. If a tax-free reorganization is done, nobody will pay any current taxes, but D will not get to step up the basis of C's assets. But if a cash transaction under section 337 or 338 is done, Y will have a large current tax liability. An alternative would be to have D issue nonreadily tradable term installment obligations, bearing a market rate of interest, for the C assets (followed by a section 337 liquidation) or stock (followed by a section 338 election). Under that approach, D would get an immediately usable basis in C's assets in an amount equal to their cost (as well as annual interest deductions), and C would have no significant tax liability. Furthermore, Y, under section 453, could generally defer paying taxes on the appreciation in the value of his C stock until D made principal payments on the installment obligations. Meanwhile, Y would be getting from D market-rate interest on the entire principal amount of the obligations (i.e., the sales price). If the consideration to Y had been cash, Y could have invested at market rates only that amount less the amount of tax currently due on his gain. In effect, section 453 would permit Y to obtain an interest-free loan from the Federal government.

Case (6): Avoiding recapture

Corporation E is a widely-held public corporation. Its assets have a tax basis which is very low relative to their value. However, most of that difference would be treated as depreciation recapture (or similar items) were E to sell its assets for their value. Neither E nor Corporation F has any significant net operating loss carryovers. F wants to acquire E.

It would not make tax sense for F to acquire E's assets in a taxable transaction or for F to acquire E's stock in a taxable transaction and make a section 338 election. In either case, F would get a step-up in basis for E's assets. However, E would have immediate ordinary (recapture) income in an amount approximating that step-up. The tax cost of that ordinary income would exceed the present value of the basis step up for the E assets. Therefore, F should consider buying the stock of E and not making a section 338 election (in which case the basis of E's assets would not change and E would have no taxable income, but the E shareholders would be taxed) or doing a tax-free reorganization with E. If such a reorgani-

[23] Suppose, instead, that C's sole shareholder in Case (4) is a tax-exempt organization or a foreign person who is not a U.S. taxpayer. Suppose further that that shareholder has a low basis in its C stock. Under these facts, C could sell its assets and liquidate under section 337, or D could buy the C stock for cash and make a section 338 election. In either event, generally neither C nor its shareholder would have any U.S. tax to pay under present law.

zation were done, again the basis of E's assets would not change, but E's shareholders would generally have a tax-free transaction.

Case (7): Use of acquirer's NOLs

The facts are the same as in Case (6) except that F (but not E) has large net operating loss carryovers that it does not expect to be able to use in the normal course of its own operations. In this case, F should consider buying all the E stock in a taxable transaction and not making a section 338 election, in which case there would be no change in the basis of E's assets. Thereafter, F could sell some or all of the E assets for their value. Assuming F and E are filing consolidated returns, F's net operating loss carryover could be used to offset the gain to E on the sale of its assets. E could then reinvest the sales proceeds in new assets, which may or may not be similar in function. As a result, the new E assets would get a new basis, and no corporate tax would ever be paid on the recapture income inherent in the old E assets (although E's shareholders would be taxed). Alternatively, the parties could do a tax-free reorganization to the same end. In that case, E's shareholders would generally have a tax-free transaction.

Case (8): Target built-in loss

Corporation G is a widely-held public company. Its assets have a tax basis which is very high relative to their value (i.e., there is "built-in loss"), and it is not currently paying taxes. Corporation H, which is very profitable and pays substantial taxes, wants to acquire G.

H should not buy G's assets in a taxable transaction or buy the G stock in a taxable transaction and make a section 338 election. In either case, the basis of G's assets would be reduced ("stepped down") to their cost, and the benefits of G's built-in loss would disappear. Rather, H should consider buying G's stock in a taxable transaction and not making a section 338 election. In that case, while G's shareholders would be taxed, there would be no change in the tax basis of G's assets. Assuming G and H file a consolidated return after the acquisition, H, subject to several limitations, would be able to make use of G's built-in loss through depreciation deductions or sales of G assets. Thus, H could receive tax benefits based on an amount substantially in excess of what it paid for the G stock. This differs from general Code principles, under which tax benefits are usually based on cost to the taxpayer.

Alternatively, G and H could combine in a tax-free reorganization, with similar results. Furthermore, in that case, G's shareholders would generally not be taxed currently.

Case (9): Acquisition by a loss corporation

Corporation I is a very profitable corporation which pays significant taxes. Its assets have a tax basis approximating their fair market value. Corporation J has net operating loss carryovers. J wants to acquire I.

J has substantial tax-planning flexibility. It could acquire the I assets in a taxable transaction, it could acquire the I stock in a taxable transaction, or it could acquire I in a tax-free reorganization. In any such case, J would be putting itself into a position where it

could deduct from future taxable income generated by I (or the former I assets) its own net operating loss carryovers from periods predating the acquisition.

Case (10): Acquisition of NOLs

The facts are the same as in Case (9) except that I has significant net operating loss carryovers and J pays substantial taxes. J should not buy I's assets in a taxable transaction or buy the I stock in a taxable transaction and make a section 338 election. If it did, I's net operating loss carryovers would not be available to it. Under almost any other acquisition form, J could acquire I, including its net operating loss carryovers. Subject to some limitations, J could then use I's pre-acquisition carryovers to offset its own (or I's) post-acquisition taxable income.

Case (11): Liquidating sales to different buyers

Corporation Q is a widely-held holding company. Its assets consist of all the stock of each of 10 operating companies, none of which is held as inventory. Q's aggregate basis in that stock is well below the aggregate value. An investor group wants to acquire Q for cash. It creates newly-formed corporation P, and P buys all the stock of Q. P does not make a section 338 election. After the purchase, P causes Q to make liquidating sales of the stock of each of its 10 subsidiaries, for cash to 10 unrelated corporate buyers, each buyer buying one subsidiary. Q and P both then liquidate, the investor group ending up with the cash received by Q on the separate sales of its subsidiaries.

Under this transaction, generally P and Q would not be taxed despite the appreciation in value of Q's holdings. The investor group would be taxed on any gain, probably at capital gains rates (as would shareholders of Q who sold their stock to P). Each of the 10 different buyers would be able to make an independent judgment as to the wisdom of a section 338 election with respect to the stock of the subsidiary it just acquired. Some probably would make an election, and some would not.

These results could also have been achieved by Q alone, without P's (or the investor group's) participation.

Case (12): Overfunded pension plan

Corporation K is a widely-held public corporation. K maintains a defined benefit pension plan established for the exclusive benefit of its employees. The plan is a qualified plan under section 401, and the related trust qualifies for tax exemption. The trust is currently overfunded by approximately $100 million. That is, if the trust were currently to be terminated, its assets would exceed the present value of the benefits accrued under the plan by K employees up to the date of plan termination. Corporation L wants to acquire K.

Under almost any form of acquisition, L, subject to some limitations, could cause K to terminate its pension plan. The termination would enable L, directly or indirectly, to obtain the $100 million. It could be used to assist L in paying for the acquisition, for general corporate purposes, or for any other purpose. While the $100 million would be included in the gross income of K (or L) upon termi-

nation of the plan, any net operating losses and loss carryovers of L (or K, depending on the acquisition form) could be used to offset that income.

If K did not desire to be acquired, it would be well-advised to terminate the plan itself and to make good business use of the proceeds. K would be a less attractive takeover candidate in that event, for it would not have $100 million in readily-available cash as an inducement to a potential acquirer.

Case (13): Leveraged acquisition

Another potential buyer of M in Case (1) may be another widely-held public company. That company could borrow the money to buy M stock. The buying company would deduct its interest expenses, thus reducing its (and M's) Federal income tax liability and increasing cash flow. Again, that increased cash flow would make it easier for the borrowed money to be repaid. Again, M would have been acquired largely with untaxed income.

It is possible that the interest deductions on the borrowing would not be large enough to fully offset M's post-acquisition taxable income. However, in a case like Case (13), the buying company could make a section 338 election after acquiring the M stock (as could MM in Case (2)). If such an election made tax sense, making it would have the effect of reducing post-acquisition taxable income. Or the buying company in Case (13) may have net operating loss carryovers or current operating losses of its own. If so, it could use those to bring post-acquisition taxable income down even further. Finally, M's buyer might cause M to transfer its assets to a partnership composed of M and an unrelated corporation having large loss carryovers. The partnership rules may permit the parties to structure the partnership in such a way that substantially all income from the former M assets would be offset by the loss company's carryovers. If so, little tax would be paid, thus making it easier for M's buyer to make debt service payments.

Case (14): ESOPs

All the stock of Corporation N is owned by individual Z. Z's basis in the N stock is substantially below its fair market value. Z wants to sell most of his N stock, and N's employees desire to buy it. Accordingly, N can set up an employee stock ownership plan ("ESOP") for its employees. N may then borrow an amount equal to, say, 80 percent of the fair market value of its stock from a bank or an insurance company. The loan may be secured by mortgages on and pledges of N's assets. N can then reloan the loan proceeds to the ESOP on substantially the same terms on which it borrowed them. The ESOP can then use the loan proceeds to buy 80 percent of the N stock from Z. The ESOP will pay off the loan with contributions made to it by N in subsequent years. Z will use the sales proceeds to invest in a portfolio of securities of public companies traded over the New York Stock Exchange.

Under section 1042, this transaction would produce no immediate tax consequences to Z. Recognition of his gain would be deferred. As a result, Z may be willing to sell his N stock for a price lower than would otherwise be the case. The bank or insurance company lender to N, under section 133, would be able to exclude from its

gross income 50 percent of the interest income on its loan to N, so it should be willing to lend at a favorable rate of interest. And N generally could deduct that part of its contributions to the ESOP used to pay off principal on its loan to the ESOP. As a result, the dollars used to buy the N stock from Z would not be currently taxable to anyone.

Case (15): Hostile takeovers

Corporation O is a widely-held public company the stock of which is traded on the New York Stock Exchange. The stock is currently selling at $40 per share. A group of investors determines that, based on the net value of its underlying assets, O is really worth $80 per share. The investor group, through a newly-created or an existing corporation, begins buying O stock, on the exchange, at $40 to $45 per share, largely with borrowed funds. After acquiring 5 percent of O's outstanding stock, the investor group's corporation makes a tender offer, at $60 per share, for the balance of O's stock. Most of the cash to be used in the tender offer would be borrowed by the tendering corporation. The investor group has financing commitments from prospective lenders under which the corporation can borrow, on an unsecured and subordinated basis, the funds it may need to finance the tender offer at an interest rate of several points over prime. The high rate on the debt ("junk" bonds) reflects the credit evaluation made by the prospective lenders.

The tender offer may be successful. If so, a section 338 election could be made, and interest payments would be deducted by the new corporation. This could reduce post-acquisition tax liability and increase cash flow available to service the debt.

If O does not wish to be acquired by the investor group, a number of other things may happen. Among them are the following 3 possibilities. First, O may try to dissuade the investor group from proceeding with the tender offer by offering to buy back the 5 percent of its stock held by the group. O may offer $60 per share. If this "greenmail" offer is accepted, O might claim (based on very dubious authority) a tax deduction for the entire $60 per share, and the investor group's corporation will probably claim that its profit qualifies as capital gain. Second, O may search around for a "white knight". If O is successful, it may find a white knight who will buy O for $65 per share. Again, the investor group's corporation will likely claim capital gain treatment. (What the white knight does in the way of acquisition planning (e.g., using borrowed money or making a section 338 election) will depend on the tax profiles of O and itself.) Third, O may set up an ESOP to buy, with borrowed funds, some of its stock. (This would assist O in fending off the acquisition attempt because the ESOP would likely be less inclined to accept the tender offer than would O's public shareholders.) Generally, 50 percent of interest payments made by the ESOP with respect to those borrowed funds would be excludible from the lender's gross income. Furthermore, O would in effect end up with deductions for contributions it makes to the ESOP to enable it to amortize the loan.

IV. PRESENT LAW RULES

Part two of this pamphlet looked, from a tax policy perspective, at how present Code rules may influence whether a corporate acquisition is done and, if so, in what form. Part three illustrated the application of those rules in the context of simplified cases. This part discusses, on a more detailed and technical level, many of the operative rules. As indicated in parts two and three, most acquisitions can, from a tax standpoint, be carried out as taxable purchases of assets, as taxable purchases of stock (with or without a secton 338 election), or as tax-free reorganizations. The tax consequences of the 3 differ greatly.

A. Forms of Acquisition

An acquiring corporation can structure the acquisition of another corporation as a taxable purchase or as a tax-free reorganization. In either case, the transaction can take the form of an acquisition of assets or an acquisition of stock. As indicated in part three, the form of an acquisition is influenced by factors such as the nature of the consideration to be used (e.g., cash, or stock or debt of a party to the acquisition), the opportunity to step up the basis of the acquired corporation's assets, and the question of whether it is advantageous to preserve the acquired corporation's tax history (e.g., net operating loss carryovers, credit carryovers, and built-in losses).

What follows is a technical description of many of the Federal income tax rules that govern corporate acquisitions involving domestic corporations, including the treatment of shareholders of acquired corporations.

1. Taxable acquisitions

If the consideration used by an acquiring corporation is cash or other property (rather than stock of the acquiring corporation or a corporation in control of the acquiring corporation), the acquisition will be a taxable purchase of the acquired corporation's assets or stock. A putative reorganization that fails to qualify for tax-free treatment, where the consideration consists of stock or a combination of stock and cash (or other property), is also treated as a taxable purchase.

a. Asset acquisitions

A taxable sale of assets by a corporation normally results in the recognition of gain or loss to the corporation unless the corporation liquidates within a prescribed period and satisfies certain other requirements (discussed below).[24] The acquiring corporation takes a

[24] This case usually involves nothing more than the sale by a corporation of only some of its assets and its continuation in business. It is not a corporate acquisition at all.

cost basis for the acquired assets (generally equal, in the aggregate, to the amount of cash and the fair market value of any property used as consideration). No gain or loss is recognized by the shareholders of the selling corporation unless the corporation distributes all or part of the sale proceeds.

Treatment of selling corporation

The selling corporation in a nonliquidating sale recognizes gain or loss equal to the difference between the amount realized (i.e., the cash and the value of any property received) and its basis with respect to each asset. Recognized gain or loss is ordinary income or loss, long-term capital gain or loss, or short-term capital gain or loss depending on the nature and holding period of the transferred property. For example, if the selling corporation recognizes a net gain from depreciable assets that were used in its trade or business and held for the period required (generally more than 6 months), then the gain may be taxed as long-term capital gain pursuant to section 1231. Ordinary income and net short-term capital gain are taxed to corporations at a maximum rate of 46 percent. A corporation's net capital gain (the excess of net long-term gain over net short-term loss) is subject to an alternative tax of 28 percent if the tax computed using that rate is lower than the corporation's tax would be using the regular rates.

Recaptures.—Part or all of the selling corporation's gain may be characterized as ordinary income under a "recapture" provision. The recapture rules, and similar rules, are generally designed to prevent the conversion of ordinary income into capital gain by requiring gain on disposition of certain property to be taxed as ordinary income to the extent of deductions previously taken against ordinary income with respect to the property.

Under the depreciation recapture rules of section 1245, gain is taxed as ordinary income to the extent of all prior depreciation deductions taken with respect to personal property. Under section 1250, if part or all of the cost of nonresidential real property qualifying as recovery property was recovered under the accelerated depreciation method, recognized gain is treated as ordinary income to the extent of all prior recovery deductions taken. On the other hand, if the property was not depreciated under an accelerated method, none of the gain is recapture income. Section 1252 provides a recapture rule for transfers of farm land. Under this provision, a portion of the post-1969 amounts deducted for soil and water conservation or clearing land is subject to recapture.

If mining property is included in the assets disposed of, recognized gain is treated as ordinary income to the extent of post-1965 mining exploration expenditures previously deducted under section 617 (reduced by the amount of foregone depletion deductions). Similarly, if oil and gas properties are sold, section 1254 provides for the recapture of amounts deducted for post-1975 intangible drilling and development costs (less the amount of foregone cost depletion deductions). Section 1254 also applies, with respect to post-1977 development costs, to transfers of geothermal property. However, depletion deductions are not subject to recapture.

In addition to the recapture of previously claimed deductions, Section 47 provides for the recapture of investment tax credits. If

eligible property is disposed of prior to the end of the period that was taken into account in computing the credit claimed by the taxpayer, then the credit is recomputed. For example, in the case of property that qualified for the regular 10 percent credit, on an early disposition, the credit is recomputed by allowing a 2-percent credit for each full year the property was held. The difference between the credit originally claimed and the recomputed credit is generally treated as a dollar-for-dollar increase in the selling corporation's tax liability for the year of sale. This recapture occurs whether the property is sold at a gain or at a loss.

Sales by liquidating corporations.—In the acquisition context, a corporation selling assets can, under section 337, avoid the recognition of gain (other than recapture and similar income) with respect to sales that occur within a 12-month period beginning on the date the corporation adopts a plan of complete liquidation by distributing all of its assets (less assets retained to meet claims) during such 12-month period. Nor will it recognize loss with respect to any such sales. Section 337 generally does not provide nonrecognition treatment on a sale of assets by a corporate subsidiary, however, unless all corporations in the chain above the subsidiary are also liquidated. Nor does section 337 generally apply if the corporation is a "collapsible corporation" (discussed below).

Ordinarily, the selling corporation recognizes neither gain nor loss on liquidating sales of assets (or on the distribution of its assets in a complete liquidation [25]). However, gain is recognized (as ordinary income) to the extent of recapture income under the rules described above. In addition, if the selling corporation maintained inventories using the LIFO (last-in-first-out) method for Federal income tax purposes, the corporation will recognize ordinary income in an amount equal to the excess of the value of the inventory using the FIFO (first-in-first-out) method over the value using the LIFO method. Furthermore, the corporation will recognize income on piecemeal liquidating sales of its inventory. Finally, investment tax credits are also subject to recapture, as described above.

In addition to the statutory recapture provisions, the selling corporation may be viewed as recognizing income on a liquidation (or a liquidating sale) under the "tax benefit" doctrine or assignment of income principle. For example, the U.S. Supreme Court has applied the tax benefit doctrine to tax a liquidating corporation on the distribution of previously expensed items to its shareholders. *United States* v. *Bliss Dairy, Inc.*, 460 U.S. 370 (1983), *rev'g*, 645

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[25] Prior to the enactment of the Deficit Reduction Act of 1984, generally no gain (other than recapture income) was recognized to a corporation that made a nonliquidating distribution of appreciated property with respect to its stock. There were several cases under prior law where the failure to tax currently the ordinary, nonliquidating distribution of appreciated property to a shareholder resulted in tax avoidance. For example, in several-widely publicized transactions, publicly-held oil companies transferred royalty interests carved out of long-held working interests in oil and gas leases to a trust and distributed units of interest in the trust to their shareholders without paying any corporate-level tax (except on recapture). Under the 1984 Act, nonliquidating distributions of appreciated property to corporate shareholders are taxable to the distributing corporation. Ordinary distributons to noncorporate shareholders are also taxed to the distributing corporation with limited exceptions. However, except for recapture, liquidating distributions are not taxable events to distributing corporations. In addition, under the 1984 Act, the basis of a corporate shareholder's stock is reduced by the nontaxed portion of an extraordinary dividend (sec. 1059).

F.2d 19 (9th Cir. 1981). Tax benefit recapture could also apply to require the recognition of income with respect to other items such as bad debt reserves.

Similar rules apply in the case of certain taxable stock purchases if a section 338 election is made (discussed below). In fact, most taxable acquisitions are cast as stock purchases. By using a stock purchase, the acquirer can more easily and deliberately assess the wisdom of a section 338 election. In the liquidating sale case, there is no decision to be made—the transaction will be treated as if such an election had been made.

Consequences to acquiring corporation

The acquiring corporation in a taxable purchase of assets takes a cost basis in the acquired assets (sec. 1012). Thus, for example, if appreciated assets are purchased, the basis of the assets are stepped up to reflect the acquiring corporation's cost, regardless of whether the selling corporation is taxed on the appreciation in the value of those assets. Similarly, if the assets purchased have depreciated in value, the basis is "stepped down" in the hands of the acquiring corporation. The acquiring corporation will not succeed to the tax history (e.g., carryovers) of the selling corporation.

The value of a stepup depends, in part, on the nature of the acquired corporation's assets. For example, because land is not depreciable, the benefit of stepping up its basis is generally realized only on a subsequent disposition of the property (by reducing taxable gain). On the other hand if the basis of a depreciable asset is stepped up, the acquiring corporation will be entitled to larger depreciation deductions than would have been allowed to the selling corporation. Likewise, a stepup in the basis of inventory will eventually be reflected in the acquiring corporation's cost of goods sold (and thereby reduce its taxable income).

Shareholders of selling corporation

In general, the sale of a corporation's assets does not generate a tax at the shareholder level. However, if the selling corporation distributes the sale proceeds in a complete liquidation, each of the corporation's shareholders recognizes gain or loss (generally capital in nature) equal to the difference between the value of the liquidating distributions and the basis of the stock (sec. 331).

Possible application of collapsible corporation rules.—The "collapsible corporation" rules are designed to prevent the conversion of ordinary income into capital gain by engaging in an activity through a corporation and, before a substantial amount of the resulting income is realized at the corporate level, disposing of the stock in the corporation at a price that reflects the unrealized earnings (sec. 341). A shareholder who receives a liquidating distribution from, or sells stock in, a collapsible corporation is generally taxed at ordinary income rates if the gain recognized would otherwise be treated as long-term capital gain. Individuals are taxed on long-term capital gains at a maximum rate of 20 percent. The maximum rate of tax on ordinary income and net short-term capital gain of individuals is 50 percent.

b. Stock acquisitions

A taxable purchase of a corporation's stock from its shareholders results in the recognition of gain or loss by such shareholders. Gain on stock sales is generally taxed at capital gain rates unless the collapsible corporation rules (discussed above) apply or the stock was not held as a capital asset. Absent an election to treat the stock purchase as an asset acquisition under section 338 (described below), no gain or loss is recognized by the acquired corporation, and the basis of its assets and its tax history are unaffected. However, the acquiring corporation takes a cost basis in the purchased stock.

In the case of widely-held acquired corporations, a common practice is for the acquiring corporation to tender for all of the acquired corporation's outstanding stock and, after purchasing a significant portion of that stock for cash (or installment debt), to cause a newly-formed subsidiary to merge into the acquired corporation under applicable state law (a "squeeze out" merger). In the merger, the acquired corporation's remaining shareholders will also receive cash (or installment debt) for their shares. A reverse merger of this type is generally treated as a taxable purchase of the acquired corporation's stock (but see the discussion below regarding tax-free reverse subsidiary mergers).

Treatment of the acquired corporation

The acquisition of part or all of a corporation's stock is generally a nonrecognition event for the corporation. Thus, the basis of the acquired corporation's assets is unchanged. Similarly, there is no effect on other tax attributes such as accumulated earnings and profits. Assuming that the transaction does not run afoul of section 269 (which authorizes the disallowance of certain benefits and deductions if the principal purpose of an acquisition was tax avoidance), net operating loss carryovers and unused tax credits, etc. will remain fully available to the acquired corporation if it continues to carry on a trade or business that was conducted before the acquisition (secs. 382 and 383).[26] Furthermore, any built-in loss of the acquired corporation will survive. Thus, the acquired corporation generally retains the ability to reduce taxes that would otherwise be paid with respect to future income.

Stock acquisitions treated as asset acquisitions.—A corporation that makes a "qualified stock purchase" (the acquisition of at least 80 percent of another corporation's voting stock and at least 80 percent of all other classes, excluding nonvoting preferred, within a specified time period) can elect to treat the stock purchase as a direct purchase of the assets of the acquired corporation (sec. 338). If a section 338 election is made, the acquired corporation is generally treated as if it had adopted a plan of complete liquidation and sold all of its assets at the close of the acquisition date under section 337. The acquired corporation is deemed to have sold its assets

[26] Section 382 imposes special limitations on the use of NOL carryovers following an acquisition. Section 383 provides similar limitations on attributes other than NOL carryovers. The rules are sometimes criticized as too generous to taxpayers and as technically flawed. 1976 amendments to the rules are generally scheduled to go into effect for taxable years beginning after 1985, but they are under reconsideration.

for a price equal to their fair market values. Nonrecognition treatment is generally provided to the acquired corporation to the same extent that gain or loss would go unrecognized if there were an actual sale and liquidation subject to section 337 (see the discussion above). Thus, for example, as in the case of a liquidating sale, the recapture rules are fully applicable.

As of the day following the acquisition date, the acquired corporation is treated as a new corporation that purchased all of the assets held by the acquired corporation. Thus, the basis of each of the acquired corporation's assets is generally stepped up (or down) to its cost to the acquiring corporation (measured by the price paid for the stock and adjusted for liabilities of the acquired corporation and other relevant items).[27] In addition, the acquired corporation's tax attributes are unavailable to the acquiring corporation.

Consequences to acquiring corporation

The acquiring corporation takes a cost basis for the purchased stock. Although the acquiring corporation does not directly succeed to the tax history of the acquired corporation, it can benefit indirectly from attributes such as NOL carryovers if the acquired corporation joins the acquiring company in the filing of a consolidated return for Federal income tax purposes and if no section 338 election is made or deemed made. If the acquired corporation is subsequently liquidated into the acquiring corporation, the acquired corporation's tax history will carry over to the acquiring corporation (unless the principal purpose of the transaction was tax avoidance).

Consolidated returns.—Generally, if, after the acquisition, the acquired corporation is included in an affiliated group of corporations that files a consolidated return, the other corporations in the affiliated group can deduct their post-acquisition losses against the acquired corporation's post-acquisition income. Conversely, losses realized by the acquired corporation after the acquisition (other than certain built-in losses, described below) will offset post-acquisition income generated by other members of the affiliated group.

In addition to the special limitations on NOL carryovers in section 382, under the "separate return limitation year" (SRLY) rules provided by regulation (see Treas. regs. sec. 1.1502-21(c)), NOL carryovers of a newly-acquired member of an affiliated group cannot offset income of other members of the group. (The "consolidated return change of ownership" rule provides similar treatment with respect to the NOL carryovers of an affiliated group acquired by certain persons.) Because an acquired corporation is permitted to use NOL carryovers to offset "its own" income, the SRLY rules can frequently be avoided by diverting income-producing activities (or

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[27] Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), a corporation could in some instances acquire the stock of another corporation in a taxable purchase and then effect asset stepups only with respect to selected assets where a stepup was most advantageous. This selectivity was achieved by causing a partial liquidation of the acquired corporation. TEFRA modified the treatment of a partial liquidation so that only certain noncorporate shareholders of the distributing corporation would be treated as receiving amounts distributed in partial liquidation as in exchange for stock. One of the principal effects of this change was to deny an acquiring corporation a stepup in the basis of properties distributed to it by a newly-acquired corporation in partial liquidation. TEFRA also adopted other rules which attempted to prohibit "selective" stepups, e.g., the consistency rules of section 338.

contributing income-producing assets) from elsewhere in the group to a newly-acquired corporation (but see sec. 269).

Applicable Treasury regulations (see Treas. regs. sec. 1.1502-15) also prohibit the use of an acquired corporation's built-in losses to reduce the post-acquisition taxable income of other members of an affiliated group. Under the regulations, built-in losses are subject to the SRLY rules. In general, built-in losses are defined as deductions or losses that economically accrued prior to the acquisition but are recognized for tax purposes after the acquisition, including depreciation deductions attributable to a built-in loss (Treas. reg. sec. 1.1502-15(2)). For example, if the acquired corporation owns a building with a basis of $100 and a value of $50 as of the acquisition date, the $50 potential loss may be treated as a built-in deduction. The built-in loss limitations do not apply unless, among other things, the aggregate basis of certain assets of the acquired corporation exceeds the value of those assets by more than 15 percent. Further, assuming that section 269 is inapplicable, the application of the SRLY rules to built-in losses can be avoided by causing the acquired corporation to generate additional taxable income (as described above).

Subsidiary liquidations.—Absent a section 338 election, and assuming no significant tax avoidance motive, a corporation can liquidate a newly-acquired subsidiary corporation and directly succeed to the acquired corporation's tax attributes (secs. 332 and 381). No gain or loss is recognized, and no recapture occurs, to the liquidating subsidiary corporation or to the distributee parent corporation (secs. 332 and 336), and the distributee corporation takes a carryover basis in the assets received on liquidation (sec. 334). The acquiring corporation's basis in the purchased stock will "disappear".

Section 381 enumerates tax attributes that carry over to a parent corporation as the result of the liquidation of a subsidiary. A major item is earnings and profits or a deficit in earnings and profits. In general, a deficit in an acquired corporation's earnings and profits cannot be applied against the acquiring corporation's accumulated earnings and profits; however, the deficit can reduce the acquiring corporation's post-acquisition earnings and profits. Thus, even if the acquiring corporation at the time of the acquisition has accumulated earnings and profits, after such earnings and current earnings are paid out as dividends the acquired corporation's deficit could result in the future payment of tax-free dividends (treated as a return of capital to the acquiring corporation's shareholders). Of course, the acquired corporation's deficit in earnings and profits may be unimportant if the acquiring corporation's accumulated earnings and profits are so great that there is no likelihood of reducing them to zero.

Examples

(1) The opportunity to step up basis

The parties to an acquisition may or may not wish to step up the basis of the acquired company's assets. As indicated, there is a tax cost (or "toll charge") to such a stepup—recapture income to the acquired company. As the examples below show, there will be many cases in which a step-up election is not advantageous. Since

those stepup and toll charge results are automatic in the case of a liquidating sale of assets by an acquired company, most taxable acquisitions are structured as purchases of stock. In a purchase of stock, stepup and recapture will occur only if the parties so elect. Further, the law gives the parties some period of time to determine whether the election should be made.

The decision to elect to step up the basis of all assets and pay recapture taxes or, alternatively, to have basis carry over and have no recapture tax, generally is determined with reference to several tax and financial attributes of the acquiring corporation and the acquired corporation. The following example illustrates the net tax benefits and costs of a step-up election under a limited and simple set of assumptions.

Assume that the acquired corporation acquired all its assets on January 1, 1981, and that all its stock is sold on January 1, 1984. Five types of assets are involved in the transaction:

(1) Section 1245 equipment, in the 5-year ACRS class;

(2) Section 1250 structures, depreciated under the straight-line method;

(3) Section 1254 intangible drilling costs (three-tenths of which would have been recovered through cost depletion);

(4) Lease acquisition costs (three-tenths of which have been recovered through cost depletion); and

(5) LIFO inventories.

Both parties are assumed to be fully taxable at a 46-percent marginal rate. The acquired corporation has no liabilities. (See Table 6.)

Table 6.—Asset Analysis and Recapture Tax

Assets	Original cost—Jan. 1, 1981	Jan. 1, 1984—			
		Tax basis	Purchase price	Recapture income	Recapture tax
Section 1245 equipment	$10,000	$4,200	$8,000	$3,800	$1,748
Section 1250 structures	10,000	8,000	12,000	.....	.....
Section 1254 IDCs	1,000	0	1,000	700	322
Lease acquisition	1,000	700	1,000	.....	.....
FIFO inventory	1,750	1,750	1,750	.....	.....
LIFO inventory (excess over FIFO)	.....	75	75	75	35
ITC	.....	.....	.....	.....	400
Total	23,750	14,650	23,825	4,575	2,505

The original cost of the assets was $23,750. After 3 years, their purchase price (and fair market value) is $23,825, while their tax basis has been reduced to $14,650. If the basis is stepped up, recapture tax of $2,505 must be paid. The net tax benefit of a step-up

transaction (determined without regard to present value considerations), after payment of recapture tax, is $1,681 (assuming that no tax benefit is to be realized with respect to the inventory and disregarding the effect on purchase price of the recapture tax liability). Because recapture tax generally is payable in the first year and the tax savings will occur over the remaining tax lives of the assets, present values must be considered. With the future cost of funds and yield on investments unknown, the parties should consider the transaction under a range of reasonable discount rates. At a 10-percent discount rate there would be a net loss of $143. At higher discount rates, the loss from a step-up transaction would be greater. No step-up election is indicated. (See Table 7.)

Table 7.—Net Benefit of Step-Up

Discount rate	Zero	10%	12%	15%	20%
Net tax savings	$1,681	−$143	−$334	−$562	−$831

On the other hand, if the facts were changed so that the fair market value (and purchase price) of the assets created by the IDCs and the lease was increased to $4,000 each, a step-up election would be indicated under any reasonable discount rate. (See Table 8.)

Table 8.—Net Benefit of Step-Up with Higher FMV

Discount rate	Zero	10%	12%	15%	20%
Net tax savings	$4,442	$1,553	$1,225	$823	$326

The parties may forego a step-up election even if the amount of projected tax savings indicates that a step up would be beneficial. There are a number of reasons for this. First, the acquiring corporation may have borrowed substantial sums of money to make the acquisition. It may have difficulty raising affordable additional funds to pay the tax liability attributable to recapture. Second, the Internal Revenue Service, on audit, may challenge the claimed results, particularly the taxpayer's claim as to the value of separate assets or their character as depreciable property. In few areas of the tax law is there more opportunity for controversy, especially if the acquired company was a large publicly-held company. As a result, there may be significant uncertainty as to the final costs and benefits. Third, no benefits will be available unless the acquiring corporation or its affiliated group has taxable income in the future against which to apply increased deductions resulting from the step up. An acquiring corporation that assumes without question that it will be able to use those benefits as they become available will be taking some risk.

(2) Preserving built-in losses

If an acquired corporation's assets have an aggregate basis that is materially greater than their value, an acquiring corporation will wish to structure the acquisition so that the basis will carry over (rather than being stepped down to reflect the acquiring corporation's cost). Maintaining the high basis of low-value assets would permit the acquiring corporation to make use of the built-in losses against post-acquisition taxable income. The following example illustrates the manner in which an acquiring corporation could benefit from a built-in loss.

Assume that the acquired corporation holds three types of property:

(1) Land with a value and basis of $1 million;

(2) Equipment that is 5-year recovery property with a value of $2.5 million and an adjusted basis of approximately $5 million, which equipment is depreciated using a straight-line method over an optional recovery period of 12 years (resulting in an annual deduction of about $833,333); and

(3) Section 1250 structures with a value and basis of $4 million.

The above example assumes that the remaining recovery period for the equipment is six years.

Assuming that the acquired corporation has no liabilities, the acquiring corporation presumably will pay at least $7.5 million for the stock of the acquired corporation. The aggregate $10 million basis would survive. Section 269 could apply to disallow depreciation deductions attributable to the $2.5 million built-in loss with respect to the equipment. See Treas. reg. sec. 1.269-3(c)(1) (to the effect that a corporation which acquires property with a built-in loss and utilizes the property to create tax-reducing deductions may be deemed to have had tax avoidance as its principal purpose). Nevertheless, the acquiring corporation may be able to utilize the built-in loss if it is able to establish that there are business reasons to rebut the presumption of a tax-avoidance motive. Because of the possible application of Section 269, and the resulting uncertainty regarding the acquiring corporation's ability to use the built-in loss, the existence of the loss may not have a significant effect on the purchase price.[28]

If the acquired corporation could be expected to generate $750,000 of pre-tax income in each of the next six years, and the built-in depreciation deductions are allowed in full, the deductions would yield a tax saving of approximately $345,000 each year (46 percent of $750,000), resulting in an after-tax rate of return equal to the pre-tax rate of return of 10 percent.

If the acquiring corporation had simply purchased the assets directly, under the statutory table provided in section 168(b) the maximum depreciation deduction that would have been available in the year of acquisition would be $375,000 (or 15 percent of the $2.5 million cost), rather than $833,333. Assuming the same 10-percent (pre-tax) rate of return, the acquiring corporation would pay tax on

[28] On the other hand, if the buyer is not worried about section 269, it should be willing to pay more than $7.5 million for the stock—$7.5 million for the assets and something more for the tax benefits that the built-in loss will provide.

$375,000 ($750,000 of income less the $375,000 depreciation deduction). Assuming a 46 percent tax rate, the after-tax return on a direct purchase would be only 7.7 percent ($750,000 less the tax of $172,500).

Because the acquired corporation's post-acquisition income in the example was insufficient to make full use of the built-in loss, the acquiring corporation may take steps to increase that income. For example, if the acquiring corporation is engaged in the same line of business as the acquired corporation, the acquiring corporation could divert business to its new subsidiary. Alternatively, the acquiring corporation could make a capital contribution of a profitable division to the acquired corporation. These steps could increase the after-tax rate of return above 10 percent.

If the equipment had a value of $3.5 million, so that the aggregate value of the acquired corporations assets was equal to 85 percent of the aggregate basis, the acquired corporation could join in the filing of a consolidated return without running afoul of the SRLY rules. Thus, any depreciation deductions in excess of the acquired corporation's needs could be used to offset income generated by other members of the affiliated group.

2. Tax-free reorganizations

In general, to qualify an acquisitive transaction for tax-free treatment, the shareholders of the acquired corporation must retain "continuity of interest" in the combined enterprise. Thus, among other things, at least a principal part of the consideration used by the acquiring corporation must consist of stock.

The definition of the term "reorganization" is found in section 368(a). This provision lists four basic types of acquisitive reorganizations involving unrelated corporations: statutory mergers (or type "A" reorganizations); stock-for-stock exchanges (referred to as "B" reorganizations); transfers of substantially all of a corporation's assets for stock (a type "C" reorganization); and bankruptcy reorganizations (or type "G" reorganizations, which may be acquisitive or divisive in character). In addition to the statutory prescriptions, other rules apply including, for example, the "continuity of business enterprise" rule. See Treas. reg. sec. 1.368-1(d). A qualified reorganization generally results in the nonrecognition of gain or loss by the acquired corporation and its shareholders except to the extent that nonqualifying consideration (or "boot") is used. Further, the acquired corporation's basis for its assets and its tax history carry over.

a. Asset reorganizations

Type A and Type C reorganizations are essentially asset acquisitions in which the acquired corporation goes out of existence. Compared to an A reorganization, the type of consideration that can be used in a C reorganization is limited. On the other hand, the acquiring corporation can pick and choose which liabilities it will assume in a C reorganization. In a type A reorganization, the acquiring corporation assumes all of the acquired corporation's liabilities by operation of law.

Statutory mergers

The type A reorganization is defined as a statutory merger or consolidation under state or Federal law (sec. 368(a)(1)(A)). The statute does not prescribe the type of consideration that must be used in a statutory merger; however, the "continuity of interest" doctrine requires that the consideration include a significant equity interest in the acquiring corporation.[29] In the transaction, the acquired corporation merges into the acquiring corporation, and the merged corporation's shareholders exchange their stock for consideration provided by the acquiring corporation. There are no express limits on the ability of the acquired corporation to dispose of unwanted assets before the merger.

"Forward" subsidiary merger.—The definition of an A reorganization also includes a "forward" subsidiary merger, in which the acquired corporation merges into a subsidiary of the corporation that provides the stock used as consideration in the merger (sec. 368(a)(2)(D)). To qualify a forward subsidiary merger as a type A reorganization, substantially all of the merged corporation's assets must be acquired. Thus, pre-merger dispositions by the acquired corporation are limited. Under Internal Revenue Service ruling guidelines, generally the "substantially all test" is satisfied if the transferred assets constitute 90 percent of the value of the net assets, and 70 percent of the value of the gross assets, held by the acquired corporation immediately before the transfer. Rev. Proc. 77-37, 1977-2 C.B. 568.

"Reverse" subsidiary mergers.—In a "reverse" subsidiary merger, a subsidiary of the acquiring corporation merges into the acquired corporation, with the acquired corporation surviving the merger (sec. 368(a)(2)(E)). Although this transaction is similar to a type B reorganization (described below), it is included in the definition of a statutory merger. The surviving corporation must hold substantially all of the properties of both corporations after the transaction. Also, in the merger, shareholders must transfer stock representing "control" of the acquired corporation in exchange for voting stock of the acquiring corporation. For this purpose, control is defined as ownership of at least 80 percent of the voting stock, and at least 80 percent of every other class of stock, of the acquired company (sec. 368(c)).

Type C reorganizations

A type C reorganization is an acquisition of substantially all of a corporation's assets "solely" in exchange for voting stock of the acquiring corporation (or of a corporation in control of the acquiring corporation) (sec. 368(a)(1)(C)). In determining whether qualified consideration is used, the acquiring corporation's assumption of a liability is disregarded. Under the "boot relaxation rule" of section 368(a)(2)(B), up to 20 percent of the consideration can consist of property other than stock of a party to the reorganization, al-

[29] Compare *John A. Nelson* v. *Helvering*, 296 U.S. 374 (1935) (where 38 percent of the consideration consisted of nonvoting preferred stock and 62 percent of cash, the requirement was satisfied), with *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462 (1933) (short-term notes did not provide sufficient continuity).

though the 20-percent limitation is reduced by the amount of liabilities assumed by the acquiring corporation.

The type C reorganization provisions are intended to apply to transactions that are functionally equivalent to statutory mergers. In a statutory merger, the acquired corporation is liquidated by operation of law. Thus, the statute requires the complete liquidation of a corporation whose assets are acquired in a C reorganization, unless this requirement is waived by regulations. Even if the liquidation requirement is waived, however, the transaction is treated as if a complete liquidation had occurred.

b. Stock reorganizations

A type B reorganization is an acquisition of stock representing control of the acquired corporation solely in exchange for voting stock of the acquiring corporation (or a corporation in control of the acquiring corporation) (sec. 368(a)(1)(B)). Unlike the reverse subsidiary merger, where the acquiring corporation must obtain control in the transaction, a B reorganization can be accomplished by a "creeping acquisition" of the acquired corporation's stock.

c. Bankruptcy reorganizations

A type G reorganization is defined as a transfer of part or all of a corporation's assets to another corporation in a title 11 or similar bankruptcy proceeding if stock or securities of the transferee are distributed in a transaction that qualifies under section 354, 355, or 356 (sec. 368(a)(1)(G)). To facilitate insolvency reorganizations, the continuity of interest doctrine (described above) is generally applied by reference to the continuing interests of creditors of the debtor (acquired) corporation.

d. Treatment of parties to a reorganization

Acquired corporation

A corporation does not recognize gain or loss on the transfer of its property for stock or securities of a corporation that is a party to the reorganization (sec. 361(a)). If the acquired corporation also receives nonqualifying consideration, then gain (but not loss) is recognized unless the boot is distributed pursuant to the plan of reorganization (sec. 361(b)). In general, the acquiring corporation's assumption of the acquired corporation's liabilities is not treated as boot.

Shareholders and security holders

Generally, no gain or loss is recognized by shareholders or security holders who exchange stock or securities solely for stock or securities in a corporation that is a party to the reorganization (sec. 354(a)). If the exchange also involves the receipt of nonqualifying consideration, gain (but not loss) is recognized up to the amount of the boot. Further, part or all of that gain may be taxed as a dividend (at ordinary income rates) if the exchange has the effect of a dividend. In general, a shareholder or security holder is treated as receiving boot if the principal amount of securities received exceeds the principal amount of securities surrendered, if securities are re-

ceived and no securities are surrendered, or if property other than stock of a corporate party to the reorganization is received.

If the exchanging shareholder or security holder receives only qualified consideration, the exchanging taxpayer takes a basis in the qualified consideration that is equal to the basis of the stock or securities surrendered in the exchange (sec. 358(a)). Thus, recognition of gain is deferred until a subsequent disposition of the stock or securities received. (The original appreciation in the acquired corporation's stock can escape taxation entirely if the shareholder holds the qualified consideration until death. In that case, the basis of the stock or securities in the hands of the taxpayer's estate will be stepped up to its fair market value.) Security holders are taxed on the receipt of qualified consideration attributable to accrued interest on securities surrendered (sec. 354(a)(2)).

Boot dividends.—The determination of whether the receipt of boot has the effect of a dividend is generally made by reference to the principles of section 302 (which provides rules for distinguishing ordinary dividend distributions from capital gain redemptions). Under section 302, a distribution is generally treated as a dividend if the distribution does not effect a significant change in the shareholder's interest in the distributing corporation.[30] In the case of an ordinary distribution, the amount is taxed as a dividend to the extent of available (current or accumulated) earnings and profits. Under section 356, however, a boot dividend is taxed at ordinary income rates only to the extent of the lesser of the shareholder's (1) gain or (2) ratable share of accumulated earnings and profits. Where a taxpayer receives boot, the basis of the boot is equal to its fair market value, and the taxpayer's basis in qualified consideration is decreased by the value of the boot and increased by the amount of any recognized gain (or dividend).

Acquiring corporation

Section 1032 provides nonrecognition treatment to an acquiring corporation that issues its stock to acquire property, even if the issuance is not part of a tax-free reorganization. Similar treatment generally is provided if a subsidiary corporation issues its parent's stock in a qualifying reorganization. See Rev. Rul. 57-278, 1957-1 C.B. 124. See also, Treas. prop. regs. sec. 1.1032-2. The acquiring corporation generally takes a carryover basis for assets or stock received in connection with a reorganization, increased by any gain recognized to the transferor on the transfer (sec. 362(b)). In addition, the acquiring corporation in an asset reorganization "steps into the shoes of" the acquired corporation with respect to earnings and profits, NOL carryovers, and other tax attributes (sec. 381). The special limitations on the use of NOL carryovers do not come into play unless the equity interest received or retained by a loss corporation's shareholders is less than 20 percent of the acquiring corporation's outstanding stock (sec. 382(b)). However, section 269 could apply to disallow NOL deductions if the principal purpose of

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[30] Compare *Wright* v. *United States*, 482 F.2d 600 (8th Cir. 1973) (dividend equivalency was measured by shareholders' continuing interests in the surviving corporation after a consolidation of 2 related corporations), with *Shimberg* v. *United States*, 577 F.2d 283 (5th Cir. 1978) (where, following a merger, the court tested dividend equivalency by assuming a hypothetical redemption by the acquired corporation before the merger).

the acquisition was tax avoidance. If the acquired corporation remains in existence (as in a type B reorganization), it can join in the filing of a consolidated return (as described above in the description of taxable acquisitions), although the SRLY rules (including those rules insofar as they relate to built-in losses) would apply.

Examples

(1) Utilization of acquired corporation's NOL carryovers

The acquiring corporation may structure an acquisition as a tax-free reorganization to preserve the acquired corporation's tax history without maintaining the acquired corporation as a separate entity. The following example illustrates the application of the rules that permit an acquiring corporation to utilize the NOL carryovers of an acquired corporation.

Assume that the acquiring corporation projects that it will have annual taxable income of $1 million for each of the next 5 years. Also assume that the acquired corporation has NOL carryovers of $20 million and that none of the carryovers will expire before the end of 5 years. The acquired corporation also has assets used in its trade or business, but these assets are not expected to generate taxable income.

If the acquired corporation is merged into the acquiring corporation under section 368(a)(1)(A), the $20 million NOL carryover will survive and be inherited by the acquirer (sec. 381). Assuming that the acquired corporation's shareholders receive only 5 percent of the acquiring corporation's outstanding stock, the present-law special limitations would disallow 75 percent (or $15 million) of the NOL carryover (sec. 382(b)). Even so, the $5 million carryover that remains available would be sufficient to cover the acquiring corporation's earnings over the next 5 years. The stock used as consideration could be nonvoting preferred stock, giving the acquired corporation's shareholders only a limited interest in the acquiring corporation.

Assuming that the acquiring corporation is taxable at a 46-percent marginal rate (and, so, would have paid about $460,000 in tax for each of the 5 years in question), the use of the acquired corporation's NOL carryover would yield tax savings of $2.3 million. Of course, the present value of the tax savings would be somewhat less than $2.3 million, depending on the discount rate used.

The special limitations on the use of NOL carryovers following a reorganization (rather than a taxable purchase) do not require that the acquiring corporation continue the acquired corporation's business, although the continuity of business enterprise doctrine may limit the acquiring corporation's ability to simply dispose of the acquired corporation's unwanted assets. In addition, section 269 may be implicated if the acquiring corporation discontinues the acquired corporation's business. See Treas. regs. sec. 1.269-6 (example (1)). Alternatively, the acquiring corporation might choose to continue the acquired corporation's uneconomic business, to head off assertions that the acquisition was tax-motivated. In any event, because of the possible application of section 269, the value of the NOL carryover may be discounted for purposes of setting the value

of the consideration paid to the acquired corporation's shareholders.

(2) Acquisitions by corporations with NOL carryovers

Instead of selling a corporation with large NOL carryovers, the loss corporation's shareholders may decide to cause it to acquire another profitable corporation in a tax-free reorganization to make use of its own carryovers. The special limitations on the use of NOL carryovers generally would not apply if the loss corporation's shareholders retained at least 20 percent of the combined enterprise.

B. Financing Aspects of Acquisitions

1. In general

Although a corporation could be acquired solely for cash that has been accumulated, after taxes, by the acquirer, virtually all mergers and acquisitions involve some—often a substantial—degree of financing. Financing may take the form of either equity (common or preferred stock) or debt. The tax consequences to the parties to a corporate merger or acquisition and their shareholders vary depending on whether debt or equity financing is used. As discussed below, the tax law contains a strong bias in favor of debt financing. Many recent acquisitions have been accomplished using a high degree of leverage.

a. Equity financing

As discussed above, if the acquirer is a corporation, it may issue its own stock in exchange for target stock or target assets. Alternatively, the acquiring corporation might obtain funds by selling its own stock in the market and then using the proceeds to acquire the stock or assets of the target.

If the merger or acquisition is accomplished through the issuance of stock of the acquiring corporation, the transaction will be tax-free to that corporation (sec. 1032) and may be tax-free to the target corporation's shareholders and the target corporation if certain requirements are met. If the transaction involves an exchange of stock or securities by the shareholders of the target corporation, and the exchange fails to qualify under the reorganization provisions of the Code, each shareholder of the target corporation will recognize gain to the extent the value of the stock or securities received exceeds the shareholder's basis in the stock or securities surrendered. Generally, the entire amount of any gain will be recognized in the year of the sale.[31]

Distributions by the acquiring corporation with respect to stock issued to finance an acquisition, whether to the former shareholders of the target corporation or to the general public, generally will not be deductible by the acquiring corporation. Moreover, these distributions will generate ordinary dividend income to individual

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[31] Similar consequences would generally follow from a nonqualifying exchange of assets by the target corporation for stock of the acquiring corporation. In certain circumstances, however, section 337 might permit nonrecognition of gain at the corporate level.

[32] Footnote eliminated.

shareholders to the extent of the issuing corporation's earnings and profits. Thus, the income reflected by these distributions generally will be subject to double taxation. Finally, in certain circumstances, payments received by the shareholders in redemption of their stock may be treated as dividend income rather than as proceeds from the sale or exchange of the stock.

One common nontax consequence of using equity rather than debt financing is that interests of the pre-acquisition stockholders of the acquiring corporation are diluted by the issuance of additional shares of stock.

b. Debt financing

An acquirer may purchase the target corporation's stock or assets using funds borrowed from domestic or foreign banks or other financial institutions, or from individual or corporate investors (e.g., pension funds or insurance companies). A corporate acquirer could also borrow from the target corporation or its shareholders by issuing its own debt obligations to the target or its shareholders in exchange for assets or stock. The stock or assets purchased with the proceeds of the debt may be pledged as security for the loan.

Subject to certain limitations,[33] interest paid or accrued on a loan is deductible by the borrower for tax purposes (sec. 163). Although payments of interest are in theory ordinary income to the lender, all repayments of loan principle are tax-free.[34] (Of course, repayments of principle will result in some taxation of the lender if the loan was part of an installment sale under section 453.)

Financing an acquisition using corporate debt does not directly affect the equity of the shareholders of an acquiring corporation. However, as discussed in parts two and three, the use of debt financing can reduce significantly the after-tax cost of an acquisition. This follows from the simple rule that the issuer of debt can deduct the amount it pays for the use of the borrowed funds (interest), while the issuer of stock cannot deduct the amount it pays to those providing the capital for the use of that capital (dividends).[35]

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[33] In limited circumstances, section 279 denies a deduction for interest on corporate acquisition indebtedness. The limitation applies to interest in excess of $5 million per year incurred by a corporation with respect to debt obligations issued to provide consideration for the acquisition of the stock, or two-thirds of the assets of, another corporation, if each of the following conditions exists: (1) the debt is substantially subordinated; (2) the debt carries an equity participation (for example, includes warrants to purchase stock of the issuer or is convertible into stock of the issuer); and (3) the issuer is thinly capitalized (i.e., has an excessive debt-to-equity ratio) or projected annual earnings do not exceed three times annual interest costs.

[34] By contrast, as noted above, payments in redemption of corporate stock may be treated as dividends (ordinary income) rather than as proceeds from a sale (which would permit the recipient a tax-free recovery of its basis in the stock).

[35] Some corporations which have sufficient earnings to pay dividends under applicable state corporate law for one reason or another may not have taxable income for Federal income tax purposes. These corporations would receive no current tax benefit from interest deductions. Instead of issuing debt obligations, therefore, they may issue preferred stock with substantial debt-like characteristics. Because of the 85 percent dividends received deduction, the preferred stock would likely be acquired by taxpaying corporations. The result is that the tax benefits of the financing (i.e., deductions for financing costs) are in part passed on to the holder of the preferred stock, which can better use them. However, as a result of the 1984 Act, if a corporation borrows the funds used to purchase dividend-paying stock, the dividends received deduction may be reduced in certain situations (sec. 246A). The amount of the reduction is determined by the degree of leverage involved.

2. Specific provisions affecting debt-financed acquisitions

a. Cost recovery allowances and installment reporting

The Accelerated Cost Recovery System (ACRS) generally permits the cost of depreciable assets acquired after 1980 to be recovered on a much more accelerated basis than assets acquired in previous years. The deductions allowed under ACRS in early periods of use of an asset are often very large when compared to the actual economic deterioration of the asset.

In some cases, the tax benefits resulting from ACRS may provide a target corporation with significant liquid assets, thus increasing its attractiveness as a takeover candidate. In addition, similar benefits may provide a large portion of the debt service costs incurred in financing an acquisition (or internally-generated cash used in the acquisition). For example, the large deductions available under ACRS in the early years following acquisition may offset income of the acquirer (in the case of an asset purchase) or of the target corporation (in the case of a stock purchase followed by a section 338 election), thus reducing tax liability. These tax savings are the equivalent of cash payments to a taxpayer.

The basis of the acquired assets for depreciation purposes is the cost of the assets or, where a section 338 election is made, the cost (with adjustments) of the target stock. Under long-established principles of tax law, the cost of an asset includes not only cash paid but the principal amount of any purchase-money debt.[36] This debt may be represented by an installment note, in which case the aggregate tax benefits available to the parties may be magnified even further. Under section 453, gain on an installment sale may be deferred and recognized by the seller as payments of principle are received if, among other things, the installment obligation received is not payable on demand or readily tradable. Thus, while the seller recognizes gain on a deferred basis (which gain generally is treated as capital gains), the purchaser immediately receives a cost basis which includes the full principal amount of the note. If a target's assets have been purchased (or its stock purchased and a section 338 election made), some or all of that cost may be allocable to depreciable assets.

Because the sales proceeds realized by a seller in an installment sale qualifying under section 453 are not reduced in the year of sale by taxes, the seller can realize a higher after-tax return on the proceeds than if the installment method were not used. Furthermore, under present law, the seller may be able to raise cash by borrowing against the installment obligation without triggering any tax consequences. If so, the primary reason for permitting section 453 to apply—that the seller has no cash with which to pay current taxes—disappears.

Example

Assume that on January 1, 1986, P Corporation purchases all of the stock of T Corporation from T's sole shareholder, A. As consideration for the stock, P gives A its non-readily tradable term in-

[36] The principal amount may be adjusted downward if the debt instrument bears inadequate interest (see secs. 483 and 1274).

stallment note with a face amount and a fair market value of $1 million. The note bears interest at an annual rate of 13 percent,[37] payable annually in arrears. The principal amount is payable in a lump sum on December 31, 1995. A's adjusted basis in his stock is $200,000, as is T's basis in its assets.

If A does not elect out of the installment method, under section 453 he will recognize no gain in the year of sale. He will report $130,000 of ordinary interest income in each of the 10 years the note is outstanding and will recognize $800,000 of capital gain income in the year the note matures (1995). The tax at that time will be $160,000.

By contrast, if A had received $1 million in cash or marketable securities in lieu of the installment note (and therefore would have been ineligible for installment reporting), he would have recognized $800,000 of capital gain income in 1986, would have paid $160,000 in taxes in that year, and would have had only $840,000 in proceeds left to reinvest. Assuming he could have invested the proceeds at the same pre-tax rate of return he earned on P's installment note (13 percent), his annual income from the reinvestment would be only $109,200 (leaving as little as $54,600 after taxes), compared to $130,000 (as little as $65,000 after taxes) if the installment method case.

Even if A uses the installment method and recognizes no gain on the sale until 1995, if P makes a section 338 election T will be entitled to an immediate stepup in basis in its assets. T's new basis will be based on $1 million, the purchase price of the T stock. To the extent T's assets are depreciable, T can immediately begin to take depreciation deductions using a $1 million basis rather than a $200,000 basis. Furthermore, P will be deducting $130,000 each year as interest expense. These deductions could be used by P to offset T's income or P's income.

b. Provisions relating to qualified pension plans

Overfunded pension plans

If a pension, profit-sharing, or stock bonus plan qualifies under the tax laws ("qualified pension plan"), a trust holding the plan's assets generally is exempt from Federal income tax. Furthermore, contributions to a qualified pension plan by an employer are deductible, within specified limits, in the year for which the contributions are made. The participants in the plan, however, are not taxed on plan benefits until the benefits are distributed.

Under a defined benefit pension plan,[38] minimum funding rules apply that require an employer to make contributions to the plan so that an employee's retirement benefit will be fully funded upon his retirement. Under certain of the permissible funding methods, an employer's funding costs are levelled over an employee's working years even though the costs of benefits earned normally increase as the employee approaches retirement age. Thus, at any

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[37] Assume that this rate is adequate for purposes of section 1274.

[38] A defined benefit pension plan is a plan under which an employee accrues ("earns") a specified retirement benefit that is not related to the amount of assets held by the plan or any account balance maintained for the employee.

time, the plan may have assets that exceed the present value of the liabilities to employees for previously accrued benefits.

In addition, in recent years, high interest rates have contributed to substantial increases in the value of the assets held in many trusts under qualified pension plans. Although these increases in value must be amortized over 15 years in calculating the employer's minimum funding costs, one effect may be that a plan's assets may be substantially greater than its liabilities prior to the time the amortization period has expired.

If a qualified pension plan is terminated, the rights of employees to benefits accrued up to the date of the plan termination must be nonforfeitable. Although a qualified pension plan must be established for the exclusive benefit of employees, present law provides that an employer is entitled to recoup excess assets on plan termination to the extent the plan has assets remaining after all obligations to employees have been satisfied (i.e., to the extent that the plan is overfunded). If the excess assets represent amounts previously deducted by the employer or earnings on those amounts, the employer is required to include the recouped amounts in gross income for the year in which the amounts are received. Other deductions or credits (including loss carryovers) that the employer is entitled to claim may be used to offset the tax on this income.

An overfunded pension plan represents a pool of assets that may make a company a target for a takeover. Conversely, this pool of assets may be used by the company to ward off a hostile takeover. In recent years, some companies with significantly overfunded pension plans have been acquired by other companies. After the acquisition, the acquiring company terminated the overfunded pension plan and used the excess assets partially to finance the takeover. It is possible that the target companies failed to take account of the value of assets in the qualified pension plan in setting a purchase price.

It has been suggested that, as companies become more familiar with the existence of excess assets in their pension plans, the role of overfunded pension plans for an acquiring company will be diminished. On the other hand, it has been argued that an overfunded plan represents an attractive source of cash even if the value of the assets are included in the purchase price. Under the latter analysis, companies with overfunded pension plans will continue to be attractive takeover targets.

Another possibility is that a company will itself terminate an overfunded pension plan to bankroll efforts to thwart a hostile takeover attempt. This can be accomplished in one of two ways. First, the company can invest the excess assets in plant and equipment, thus making itself less attractive than if it held a large amount of liquid assets. Alternatively, the company can establish an employee stock ownership plan (ESOP) funded with the excess assets.

Employee stock ownership plans

An ESOP is a part of a stock bonus or money purchase pension plan that invests primarily in the securities of the employer. ESOPs are accorded preferential tax treatment under the Code as an incentive to participation by employees in their employer. Thus,

ESOPs are exempt from tax under the rules generally applicable to qualified pension plans, and, subject to statutory limitations, employer contributions to an ESOP are tax-deductible.

An ESOP that borrows funds to purchase employer securities is referred to as a "leveraged ESOP." An employer may deduct the full amount of any contribution to a leveraged ESOP that is used by the ESOP to pay interest on a loan to purchase employer securities and may deduct amounts used to repay loan principle up to 25 percent of payroll costs.

The Deficit Reduction Act of 1984 added additional tax incentives to the establishment and use of ESOPs, including the following:

(1) A taxpayer owning qualified securities in an employer corporation may defer recognition of gain on the sale of the securities to an ESOP that holds at least 30 percent of the employer's securities, to the extent the taxpayer reinvests the proceeds in securities of certain domestic corporations.

(2) A corporate employer may deduct dividends paid on employer stock held by an ESOP and allocated to participants' accounts if the dividends are paid currently to employees.

(3) A bank, insurance company, or corporation actively engaged in the business of lending money may exclude from its gross income 50 percent of the interest received with respect to any loan the proceeds of which are used by an ESOP to purchase employer securities.

A leveraged ESOP can be used by an employer as a financing tool to obtain funds for working capital, plant expansion, or other purposes. Often this funding method results in a much lower cost of borrowing than would be available if conventional debt or equity financing were used. In a typical transaction, the employer enters into a contract with the ESOP to sell the ESOP a specified number of shares of its stock. The ESOP borrows the funds needed to purchase the shares from a bank or other lender and pays them over to the employer in exchange for the stock.[39] In subsequent years, the employer makes tax-deductible cash contributions to the ESOP in the amount necessary to amortize the loan principal and make interest payments thereon.[40]

A leveraged ESOP may be used not only to provide the company with working capital but also to finance an acquisition of the stock or assets of another corporation. In a typical case, a leveraged ESOP maintained by the acquiring corporation or its subsidiary borrows funds in an amount equal to the amount needed to acquire the target corporation. The proceeds of the loan are used to purchase employer securities. The employer (or the subsidiary) then uses the proceeds of the sale to purchase the stock or assets of the target company. Again, the employer's contributions to the leveraged ESOP to enable it to amortize the loan will be deductible. In

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[39] The lender usually requires either that the employer guarantee the loan or that the stock purchased with the loan proceeds be pledged as collateral. Because of the 50-percent interest exclusion available to the lender, it may be able to lend to the ESOP at a lower rate—as low as 80 percent of the existing prime rate—than it lends to its regular customers.

[40] Alternatively, the employer may take out the loan itself and sell its stock to the ESOP in exchange for the ESOP's installment note. The employer will make (deductible) contributions to the ESOP in future years that will enable the ESOP to pay off the note. These payments will be used by the employer to repay its lender.

this manner, the corporation will have significantly reduced its after-tax cost of financing the acquisition.

One variation of this leveraged-ESOP financing technique is for the employer to purchase target stock, either directly or through a subsidiary, using funds borrowed from a financial institution or other lender. Once the acquisition has been completed, the newly-acquired subsidiary establishes a leveraged ESOP. The ESOP borrows money and purchases stock in the subsidiary from the subsidiary (or from the acquiring corporation). The acquiring corporation then uses the proceeds of this sale to pay off the original acquisition loan. The subsidiary makes annual, deductible contributions sufficient to amortize the ESOP loan and pay interest.[41]

Recently, leveraged ESOPs have been used in some situations to thwart hostile corporate takeover attempts. By selling stock to an ESOP, a company may make it difficult for a hostile bidder to acquire control, since stock held by an ESOP generally can be expected to be voted to keep the company independent. Proceeds of the sale are generally available for any purpose, including the payment of greenmail. Moreover, a sale of stock to the ESOP will not necessarily dilute management's control of the company to the same degree as a sale to outside parties. The stock purchased by an ESOP is not immediately credited to employees' individual accounts but is held in a suspense account and released for allocation to employee accounts only as the loan is repaid with employer contributions. During this period, the shares may be voted by plan trustees appointed by management. Furthermore, in some cases the shares sold to the ESOP have more limited voting rights than are normally granted to shareholders of public companies. Thus, the employees' ability to control policy and management decisions may be limited.

Leveraged ESOPs have also been used to accomplish leveraged buy-outs by company managers desiring to "take the company private", that is, to remove it from public ownership.

An incidental effect of leveraged ESOP financing of an acquisition is that the equity interests of the employer's pre-acquisition shareholders may be diluted. This dilution may occur as well, however, in any equity financing arrangement, including a merger with another corporation in which stock of the surviving corporation is issued to the former shareholders of the target.

Other issues relating to qualified pension plans

In addition to the potential use of qualified pension plans (including ESOPs) as financing tools in mergers and acquisitions, other issues are presented when companies, who maintain qualified pension plans, merge. These issues depend, in part, upon whether the successor company continues to maintain any of the qualified pen-

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[41] If the management and shareholders of the target company cooperate in the acquisition, it is possible that a portion of the proceeds of the sale of target stock by original target shareholders would qualify for tax-free rollover under section 1042. Thus, the acquiring corporation and the target shareholders could agree in advance that a portion (enough to qualify the ESOP as a 30-percent shareholder) of their shares would be purchased by a leveraged ESOP established by the target and the balance by the acquiring corporation. The proceeds of the sale to the ESOP might qualify for tax-free reinvestment under section 1042.

sion plans of the predecessor company. A full analysis of these issues is beyond the scope of this pamphlet.

c. Provisions relating to international taxation

Interest and dividends paid to foreign lenders and shareholders

In general, U.S. source dividends and (prior to the 1984 Act) interest paid to a nonresident alien individual or foreign corporation that are not "effectively connected" with the conduct of a U.S. trade or business of the individual or corporation are subject to tax at a flat rate of 30 percent (secs. 871 and 881). The payor is obligated to withhold the appropriate amount of tax (secs. 1441, 1442). Interest and dividends paid by a U.S. corporation on its debt obligations are generally treated as U.S. source income.

In many cases, the interest withholding tax imposed by sections 871 and 881 of the Code is reduced or eliminated by the provisions of an income tax treaty between the United States and the country in which the recipient resides. Furthermore, under the 1984 Act, interest paid to certain foreign persons with respect to certain portfolio debt investments is wholly exempt from U.S. tax. Accordingly, interest that is fully deductible by a U.S. corporate payor may be received wholly free of U.S. taxation by the foreign lender.

U.S. source dividends, although not deductible by the U.S. payor, may also be subject to a reduced withholding tax pursuant to a treaty between the United States and the shareholder's country of residence.

Sourcing of interest expense

A U.S. taxpayer may generally claim a credit against its U.S. tax for income taxes paid to a foreign government. In order to prevent foreign taxes from offsetting taxes on U.S. source income, however, the Code limits the credit to the amount of U.S. tax that would have been payable on the foreign income. The maximum foreign tax credit available to a taxpayer in a particular year is the amount of the foreign tax multiplied by a fraction the numerator of which is the taxpayer's foreign source taxable income and the denominator of which is its worldwide taxable income. Thus, a corporation increases its limiting fraction, and hence its usable foreign tax credit, to the extent it can treat income as foreign source income. The same result is achieved when an expense is treated as U.S. rather than foreign source.

A multinational corporation (one with significant foreign as well as domestic assets and earnings) seeking to acquire a domestic corporation using borrowed funds may not be able to increase the utility of the foreign tax credit by virtue of the borrowing. Treasury regulations require that a taxpayer's interest expense be allocated between U.S. and foreign source income based on the relative value of the taxpayer's assets. Thus, the multinational's foreign assets would normally attract a portion of the interest on the acquisition indebtedness.

The sourcing rules under present law, however, provide ample opportunity for manipulation by a corporation seeking to maximize its foreign tax credit utility. To avoid having the interest expense on acquisition indebtedness reduce its foreign source income and

hence the foreign tax credit limitation, the corporation may have the acquisition indebtedness incurred by a related corporation (*e.g.*, a parent holding company) whose income is entirely derived from U.S. sources. In this manner, the interest expense would not affect the corporation's foreign tax credit, but, as a member of the parent's affiliated group, the corporation would nonetheless receive the benefits of the acquisition indirectly.

d. Provisions relating to partnerships

The tax law permits a partnership to flow through to its partners items of deduction and loss paid or incurred by the partnership. In some cases, general or limited partnerships have been used to acquire the stock (or assets) of a target corporation, using both funds borrowed by the partnership from institutional lenders and funds contributed as equity by the partners. Any interest paid on the acquisition indebtedness is deductible by the partners, generally on a pro rata basis although special allocations may be possible.

In these situations, no dividends received deduction is available to a partnership or its individual partners with respect to dividends received from the target corporation. However, to the extent the partners are not corporations, dividends received will not trigger the extra 6.9 percent tax imposed on most intercorporate distributions. Furthermore, the partnership may end up owning and operating the business of the target corporation directly, including after a section 337 or section 338 transaction. In such a case, tax benefits generated by the business will pass through directly to the partnership's partners, again, generally on a pro rata basis although special allocations may be possible.

The partnership provisions may also permit an acquired corporation to shelter taxable income with loss carryovers of an unrelated corporation, thus making it easier for any money borrowed in connection with the acquisition to be paid off with pre-tax dollars.

In addition, certain nontax considerations (e.g., securities laws) may make a partnership preferable to a corporation as an acquisition vehicle.

C. Golden Parachutes

Corporations are generally permitted a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Generally, reasonable compensation for salaries or other compensation for personal services actually rendered qualifies as ordinary and necessary expenses. In recent years, many corporations have entered into arrangements, commonly called "golden parachutes", to provide substantial payments to top executives and other key personnel of the corporation in connection with any acquisition that might occur.

Golden parachutes are designed in part to dissuade an interested buyer, by increasing the cost of the acquisition, from attempting to proceed with an acquisition. If the takeover does not occur, the target's executives and other key personnel would more likely retain their positions, so the golden parachute could effect the preservation of the jobs of such personnel. Where no takeover had yet commenced but the corporation viewed itself as an unwilling potential

target, golden parachutes were often entered into to discourage potential buyers from becoming interested.

Sometimes, an acquiring corporation will enter into long-term employment contracts or similar arrangements with key personnel of the acquired corporation. These arrangements can remove the incentive for such personnel to examine a proposed takeover carefully.

The 1984 Act imposed significant tax burdens on the use of certain kinds of arrangements of a type described. Under the 1984 Tax Act, no deduction is allowed for "excess parachute payments." Further, if any such payment is made by the acquiring company, or a shareholder of the acquired or the acquiring company, it will not be treated as part of the acquiring company's purchase price for the acquired company, or as increasing the shareholder's basis in his stock in the acquired or acquiring company. Finally, a nondeductible 20-percent excise tax is imposed on the recipient of any excess parachute payment.

V. POSSIBLE CHANGES IN THE TAX RULES APPLICABLE TO MERGERS AND ACQUISITIONS

Some of the Federal income tax rules described above may be responsible, in whole or in part, for the recent surge in merger and acquisition, and attempted merger and acquisition, activity. The following changes, among others, in the applicable tax rules might be considered. Several of the suggestions (e.g., those relating to installment sales) would have ramifications well beyond the merger and acquisition area and would need to be considered in that light. Other of the suggestions are more limited.

Mandatory asset acquisition

In many respects, the taxable acquisition of a substantial, controlling stock interest in an acquired corporation is the acquisition of the assets of that corporation. The acquiring corporation indirectly gains control of those assets, and it may obtain direct control of them.

One possible change would be to require the acquisition of a controlling stock interest in a corporation in a taxable transaction to be treated as an acquisition of the assets of the acquired corporation rather than as an acquisition of its stock. One result would be to require the acquired corporation to recognize gain (or loss) with respect to its assets. This required recognition might be limited to present-law recapture items or it might be expanded (in which case a change in the rules relating to liquidating sales of assets and in-kind liquidations would also be appropriate). Another result would be to require the acquiring corporation to take a cost basis in all those assets, be it a "stepped-up" or "stepped-down" basis. A third result would be to prevent the acquiring group from succeeding to any tax attributes (e.g., net operating loss carryovers) of the acquired company.

Present law, which provides the parties with an election to achieve the results indicated, may be viewed as unduly generous. However, changing the rules in the manner proposed would tend to reduce the price at which shareholders of some acquired corporations could sell their stock and might inhibit the consummation of what would have been an efficient acquisition.

H.R. 1003 (Mr. Jones) and S. 632 (Sen. Chafee) would both require a target corporation to recognize all gain as though it had disposed of all its assets in the normal course of its business. The rule would apply in the case of a qualified stock purchase (as defined under present law section 338), but only if the acquisition was a "hostile" acquisition.

Effect of election to treat a stock acquisition as an asset acquisition

Alternatively, the law could be changed to modify the Federal income tax consequences of electing under present law to treat a

qualifying stock acquisition as an asset acquisition (with appropriate conforming changes). For example, one consequence of such an election could be full recognition of all gain (or loss) with respect to the acquired company's assets. Present law permits the acquirer to step up to fair market value the basis of all the assets of the acquired company but does not require the acquired company to recognize as taxable income any appreciation in the value of its assets (except for recapture items). This result is inconsistent with a pure two-tier tax system and differs from what would have happened had the acquired company not been acquired.

More narrowly, the recapture rules applicable under present law in the case of an election could be tightened. For example, the acquired company could be required to recognize all gain or loss on property which if sold by it outside of an acquisition context would have generated ordinary income or loss (e.g., all inventory, including FIFO inventory). Gain on all section 1250 property (certain real property) could be required to be included in income, as ordinary income or capital gain, to the extent of prior depreciation deductions allowed. This would tend to conform the section 1250 rules with those of section 1245 (relating to personal property and certain real property). Gain on all mineral property could be required to be included in income to the extent of prior intangible drilling costs with respect to such property which were deducted, regardless of whether they were deducted before or after January 1, 1976, or whether the deductions exceeded what could have been recovered through depletion deductions had they been capitalized. Finally, gain on all mineral property could be required to be included in income to the extent of prior depletion deductions allowed, or, alternatively, to the extent percentage depletion deductions allowed with respect to such property exceeded those that would have been allowed under cost depletion.

It has been argued that there is little justification for permitting an acquired corporation to avoid being taxed on the value of its ordinary income assets in excess of their basis. As for tightening the recapture rules, the acquired corporation, in claiming depreciation and depletion, became entitled to tax benefits. Appropriate recapture rules, it is argued, would do nothing more than require an acquired company to return those tax benefits to the Federal government at the appropriate occasion.

In 1983, the staff of the Senate Finance Committee published a report entitled "The Reform and Simplification of the Income Taxation of Corporations".[42] The report contains numerous proposals to revise the treatment of shareholders and corporations. Perhaps its most significant proposal with respect to acquisitions would be a proposal requiring the recognition of all gain by a target corporation on liquidating sales and liquidating distributions and other taxable acquisitions of a target's stock or assets. The deterrent effect that such treatment might otherwise have on acquisitions would be ameliorated to some extent by permitting acquiring corporations to elect to preserve the target's basis for its assets and tax history without recognition of gain (i.e., tax-free treatment), re-

[42] S. Prt. 98-95, 98th Cong., 1st Sess., (September 22, 1983).

gardless of the nature of the consideration furnished by the acquirer. Furthermore, under the proposal, some relief might be provided to shareholders of the acquired company to adjust for tax liabilities of the acquired company that the basic proposal would generate.

Both H.R. 1003 and S. 632 would, as indicated, treat the acquired corporation in a hostile stock acquisition transaction as engaging in a fully-taxable transaction, i.e., without any section 337 relief. Moreover, S. 632 would not permit the acquirer to treat as part of its purchase price (or as part of the basis of the assets deemed acquired) tax liability of the acquired corporation attributable to the deemed sale.

Net operating loss carryovers

It appears to be the case that net operating loss carryovers of either the acquired or the acquiring corporation play an important role in some mergers and acquisitions. In considering what changes, technical or otherwise, should be made to present-law section 382, Congress may wish to consider whether the current rules are too generous.

Interest expense

Because interest is deductible and dividends are not, present Code rules clearly provide a strong tax incentive for corporations to finance themselves with substantial debt capital. While the impact of the rules is certainly not limited to the acquisition context, the income tax law frequently motivates acquisitions by permitting taxpayers to deduct currently interest paid or accrued on debt (including installment debt) incurred in connection with an acquisition. Many acquirers (and acquired companies) are in a position to use those interest deductions to offset income that would otherwise be taxable at a rate at or near 46 percent. (Meanwhile, the lender (which may be a foreign person, a tax-exempt entity, an insurance company, or a domestic financial institution) may not be taxable at a 46 percent rate, or at all, on the interest income.)

While from a tax standpoint many corporations would be well-advised to leverage their capital structures to the maximum extent possible, there are non-tax reasons to resist that pressure. Chief among them, perhaps, is the general notion that the higher a corporation's debt-equity ratio is, the more precarious will its long-term financial position be. This, for example, if the company's fortunes take a downturn, it may be unable to generate sufficient cash to enable it to service its debts. If so, its lenders may be forced to foreclose on the debt, with unpredictable results for the company, its employees, its customers, and the communities in which it has a significant presence. Thus, a corporation which increases its debt-to-equity ratio to fend off an unfriendly takeover attempt may be jeopardizing the future of those interested in its well-being.

A possibility for change would be to disallow deductions with respect to interest paid or accrued on debt (including installment debt) incurred in connection with the acquisition of a company. A similar possibility would be to disallow deductions for interest paid or accrued in connection with a hostile stock acquisition. H.R. 1003 and S. 632 would do this (although the rule of H.R. 1003 would not

apply if the purchaser is a corporation). Such a rule, if it could be implemented properly, would take pressure off companies that did not want to be acquired but were unwilling to significantly increase their debt burden. Alternatively, the deduction may be disallowed only for interest paid or incurred on "junk" bonds. (See H.R. 1100 (Mr. Jones).) "Junk" bonds, as defined in that bill, are debt obligations which, under general Code rules, look very much like equity and perhaps should be treated by the issuer as equity. The junk bond proposals should be compared to present-law section 279. That section also disallows the deduction of interest on certain kinds of nominal debt instruments which have significant equity characteristics.

The recent Treasury Department proposal (November 1984) would allow a corporation to deduct 50 percent of the dividends it pays. Such a rule would reduce the potential double tax burden on corporate earnings to a tax of not more than 150 percent of such earnings. The extent to which this rule would affect acquisition activity is conjectural, but, to the extent the relative tax cost of operation in corporate form was lessened, any undervaluation of corporate assets reflected in the market price of stock which is attributable to double taxation may be reduced. Furthermore, the Treasury proposal would also have the salutary effect of reducing the tax incentives for capitalizing a corporation with debt rather than equity. Similar results might follow from the Treasury's proposal to index interest expense and income.

On a related but different point, another possibility for change would be to correct the rules to require, in appropriate cases, that interest paid or accrued by a member of a consolidated return group on debt incurred in connection with an acquisition (or any other debt) be allocated between domestic and foreign sources on a group basis. This rule might prevent an acquiring corporation from being able to allocate interest expenses away from foreign sources merely because the acquiring corporation uses subsidiaries rather than divisions to conduct business abroad. The Treasury proposal advocates such a rule.

Installment sales

Under present law, the acquiring corporation can use installment obligations to make an acquisition. Under the installment sale rules, the sellers frequently defer recognition of gain, recognizing it only as principal payments on the installment obligations are received. On the other hand, the acquiring corporation gets a new basis in the acquired property equal to the total amount of principal payments to be made over time. Particularly if the transaction is an asset purchase (or a stock purchased which the acquiring corporation elects to treat as an acquisition of assets), that basis may produce short-term tax deductions for the acquiring corporation.

This mismatching of gain and deduction, which may be offset to some extent by recapture, might be corrected. One possibility would be to give the acquiring corporation the benefits of a new tax basis only if and as principal payments on the installment obligations are made.

Another possibility would be to require the holder of an installment obligation to pay interest on the "interest-free loan" from the

government contemplated by present-law section 453. In addition, the law might be amended to provide that deferral of gain recognition would cease when its holder borrows against it. The recent Treasury Department proposals support that last suggestion.

ESOPs and overfunded pension plans

The role of ESOPs and overfunded pension plans in the merger and acquisition context could be studied and changed where and as appropriate.

"Greenmail"

The 1984 Act imposed significant tax burdens on parties to certain golden parachute contracts and similar arrangements. H.R. 1100 would impose an excise tax of 50 percent on all "greenmail" profits, as defined by the bill. Under S. 632 (Senator Chafee), it would be made clear that no deduction would be allowed for greenmail payments.

Other

The Appendix suggests some additional technical changes in the merger and acquisition rules, and related rules, which Congress might consider.

APPENDIX

ADDITIONAL POSSIBLE CHANGES OF A TECHNICAL CHARACTER RELATING TO THE TAXATION OF CORPORATIONS AND THEIR SHAREHOLDERS

1. Return-of-capital distributions

Present Law

In general, the amount of a distribution by a corporation to a shareholder is includible in the shareholder's gross income as a dividend (taxable at ordinary income rates) to the extent the distribution is made out of the corporation's earnings and profits. If the distribution exceeds the corporation's earnings and profits, the balance is applied against and reduces the basis of the shareholder's stock. To the extent the distribution exceeds the basis of the stock, the excess is treated as gain from the sale or exchange of property.

Possible Change

In the case of a distribution that exceeds the distributing corporation's earnings and profits, consideration could be given to treating the distribution as a proportionate sale of the underlying stock.

2. Pre-acquisition dividend strips

Present Law

A corporate shareholder is generally permitted to deduct 85 percent of the amount of dividends received from domestic corporations. Because the maximum rate of tax on income received by a corporation is 46 percent, the maximum tax on dividends received by a corporation is only 6.9 percent. Thus, corporate shareholders of an acquired corporation have an incentive to realize the corporation's earnings in the form of dividends rather than as capital gain on a sale of stock. Toward this end, preparatory to an acquisition, corporate shareholders may in some cases attempt to cause the acquired corporation to distribute earnings that are taxable as dividends, resulting in a reduction in the sale price of the stock and hence in capital gain. Compare *Waterman Steamship Corporation* v. *Commissioner,* 430 F.2d 1185 (9th Cir. 1970), cert. denied, 401 U.S. 939 (1971) (a susidiary's distribution of a short-term note, which was paid off by the acquiring corporation after it obtained control, was recharacterized as a payment for stock in the subsidiary), with *TSN Liquidating Corporation* v. *United States,* 624 F.2d 1328 (5th Cir. 1980) (where the corporate shareholder of the acquired corporation succeeded in establishing that a pre-acquisition dividend was not disguised consideration for a sale of stock). See also Rev. Rul. 75-493, 1975-2 C.B.

Possible Proposal

Dividend distributions to corporate shareholders before a stock sale could in precribed cases be treated as additional sales price.

3. Redemptions through use of related corporations

Present Law

Section 304 was designed to prevent shareholders from drawing off a corporation's accumulated earnings and profits at capital gain rates through the device of having a related corporation purchase stock held by the controlling shareholders. The application of section 304 to noncorporate shareholders could result in the treatment of what would be long-term capital gain (taxable at a maximum rate of 20 percent) as dividend income (taxable at a maximum rate of 50 percent). In contrast, corporate shareholders benefit from the transmutation of long-term capital gain (generally taxed at a maximum rate of 28 percent) into tax-favored dividend income (generally taxed at a maximum rate of 6.9 percent).

Possible Change

Consideration could be given to making section 304 inapplicable to the transfer of stock by corporate shareholders. The tax results under section 304 could also be more closely conformed to those under section 368(a)(1)(D).

4. Section 351

Present Law

Section 351 provides nonrecognition treatment if one or more shareholders transfer appreciated property to a corporation in exchange for stock in such corporation, and, immediately after the exchange, such persons are in control of the corporation. In one widely-publicized transaction, the minority shareholder of an acquired corporation obtained tax-free treatment under section 351 on the receipt of stock, in the context of a larger acquisitive transaction in which the acquiring corporation obtained a cost basis for the controlling stock interest in the acquired corporation (setting the stage for a liquidation that could have stepped up the basis of the acquired corporation's assets under the predecessor of section 338). The Internal Revenue Service ruled publicly that a purported section 351 exchange that is an integral part of a larger acquisitive transactive must satisfy the continuity of interest doctrine (see Rev. Rul. 80-284, 1980-2 C.B. 117). This ruling was revoked in 1984 (see Rev. Rul. 84-71, 1984-1 C.B. 106).

Possible Change

It may be advisable to provide statutory authority for the integration of a section 351 exchange and a related taxable purchase of an acquired corporation's stock. Changes to harmonize the tax results in section 351 transactions and tax-free reorganizations may also be appropriate.

5. Dividend-within-gain limitation in boot dividends

Present Law

The amount of dividend income recognized by an exchanging shareholder on the receipt of nonqualifying consideration in a reorganization cannot exceed the amount of gain.

Possible Change

Consideration could be given to repealing the rule that treats boot as a dividend only to the extent of gain.

6. Treatment of exchanging security holders in reorganizations

Present Law

If a security holder exchanges debt instruments in a reorganization, the new debt instruments are treated as qualified consideration unless the principal amount of securities received exceeds the principal amount of the securities surrendered. Given time value issues, basing tax, consequences on "principal amount" is distortive.

Possible Change

The amount of nonqualifying consideration received by an exchanging security holder could be measured by the difference between the adjusted basis of securities surrendered and the issue price of securities received.

7. Coordination of sections 357 and 361; amendment of sections 311 and 337

Present Law

In general, no gain is recognized by an acquired corporation whose liabilities are assumed by an acquiring corporation in connection with a tax-free reorganization. Nevertheless, if the acquired corporation uses consideration received from the acquiring corporation to pay off its liabilities, the acquired corporation may be treated as realizing taxable gain. See generally *Minnesota Tea Company* v. *Helvering,* 302 U.S. 609 (1938) (under which an acquired corporation's distribution of boot to a creditor was not treated as a distribution "in pursuance of the plan of reorganization" for purposes of the nonrecognition rules of section 361(b); and *FEC Liquidating Corporation* v. *United States,* 548 F.2d 924 (Ct. Cl. 1977) (the application of which would also deny nonrecognition treatment under section 337 on a "deemed sale" of stock to a creditor). But see *General Housewares Corporation* v. *United States,* 615 F.2d 1056 (5th Cir. 1980) (holding that section 337 can apply where the acquired corporation sold part of the stock received as consideration for its assets in a C reorganization and used the sale proceeds to pay debts).

Possible Change

Subject to existing restrictions in section 357 (b) and (c), section 361 could be amended to prevent the recognition of gain by an acquired corporation that uses consideration received in a tax-free reorganization to pay off debts but otherwise to tax it on sales of assets (or the distribution of property not transferred to the acquirer) in the context of a reorganization.

8. Depreciation recapture is certain tax-free exchanges

Present Law

Under present law, a taxpayer can effectively assign ordinary recapture income to another taxpayer by transferring depreciable property in a tax-free exchange. For example, section 1245(b) provides an exception to the recapture rule for depreciable personal property where the property is transferred in a section 351 exchange. Similarly, an acquired corporation recognizes no recapture income if it transfers depreciable assets in a C or A regorganization. If depreciable property is transferred to a corporation that has net operating losses, for example, no tax may be imposed on the recapture income.

Possible Change

Consideration could be given to applying the recapture rules generally when an asset is no longer accounted for on the return that benefitted from the previously-claimed deductions. Thus, there generally would be recapture in all otherwise tax-free acquisitive reorganizations as well as when a subsidiary is no longer included in the consolidated return of the affiliated group that claimed the deduction. In a section 351 exchange, the shareholder's stock might be tainted so that ordinary income would result on disposition of the stock to the extent of recapture income at the time of the section 351 transfer (with a corresponding basis adjustment to the corporation when the shareholder is taxed).

9. Acquisition of small enterprises by large publicly-held corporations

Present Law

Under present law, the exchange of stock in a small enterprise for marketable stock in a publicly-held corporation can qualify for tax-free treatment, even though the effect of the exchange resembles a liquidation of the shareholder's interest in the old corporation. Furthermore, some reorganization forms permit the use of nonvoting stock or preferred stock.

Possible Change

Consideration could be given to denying reorganization treatment to any transaction in which less than 20 percent of the outstanding stock of the acquiring corporation is received by the acquired corporation's shareholders (i.e., a transaction where the acquiring corporation is more than four times larger than the ac-

quired corporation). Such a transaction would be taxed at the corporate and the shareholder level. Furthermore, the use of voting common stock could be required in all reorganization forms.

10. Conversion of a C corporation to an S corporation

Present Law

In general, an S corporation is not subject to tax but is treated as a conduit, similar to the treatment of partnerships. Thus, shareholders who elect to treat their existing closely-held corporation as an S corporation effect a material change in the tax character of their investment. Nevertheless, the conversion of a C corporation to an S corporation is not a taxable event.

Possible Change

An election to convert C corporations to S corporations, or certain acquisitions by S corporations of C corporations, could be treated as taxable events, at least with respect to recapture income.

11. Use of shell corporations to convert short-term capital gain into long-term capital gain

Present Law

In general, gain on the sale of stock that is a capital asset held for more than 6 months is taxed as long-term capital gain, at rates that are more favorable than those applicable to short-term capital gain. If an acquiring corporation or an investor purchases and sells stock of another corporation through a holding company the stock of which has been held for more than 6 months, it may recognize long-term capital gain, even if the holding company's only significant asset is that stock and even if that stock has not been held for the period required for long-term capital gain treatment.

Possible Change

Consideration could be given to looking through a corporation whose stock is sold for purposes of determining whether the applicable holding period is satisfied. This rule could apply to closely-held corporations substantially all of whose assets (excluding cash and marketable securities) consist of recently-acquired property.

Chairman RANGEL. Mr. Chairman, might I ask Mr. Brockway, since he does not have a prepared statement, to try to respond to some of the questions that you have heard the members ask. While you hear from the Senators that testified, if would be helpful.

We are concerned about where you draw the line between hostile and friendly and whether or not it should be up to the tax-writing committee to remove those incentives because of the abuses.

Chairman PICKLE. Were you here this morning for all the testimony?

Mr. BROCKWAY. Yes, Mr. Chairman.

Chairman PICKLE. Please proceed with such statement as you can now, by way of summation, touching on some of the questions raised this morning, if possible.

Will you proceed?

Mr. BROCKWAY. Yes, Mr. Chairman.

To begin with, the treatment of mergers and acquisitions is one of the more complex and difficult areas of the tax law. Moreover, the transactions involve a great variety of factual situations, with the result that the potential combinations of tax advantages and disadvantages presented in these transactions are almost unlimited.

Because of this, it is almost impossible to put the subject in an easily digestible, coherent framework. I will therefore, try only to give an overview of the issues involved, and I will pass over many of the important issues and points.

I wish to emphasize at the outset that it is my belief that mergers and acquisitions are largely driven by nontax factors.

Mr. FLIPPO. Would the gentleman yield at that point? Would the Chair permit a question at that point?

Chairman PICKLE. You have the floor, Mr. Flippo.

Mr. FLIPPO. You say it is your view that tax is not the driver for mergers and acquisitions.

Mr. BROCKWAY. It is not the only driver; it is not the primary driver in most cases.

Mr. FLIPPO. Do we have any evidence either way on that point?

It is a very important point. Is there any evidence that tax is or is not the main driver?

Mr. BROCKWAY. While I don't think that taxes are the primary driving force in all, or even most, transactions, they clearly are an important factor in many transactions, and in some, they clearly are the primary driving force.

How important a factor taxes are really depends upon the specific facts of the situation. You cannot make a blanket statement for all transactions.

Mr. FLIPPO. I am just trying to understand whether or not there have been any studies that have been conclusive on this point, either way, that you are aware of.

Mr. BROCKWAY. Well, there are very clearly transactions where the primary motivating force is the tax consequences. There are a great number of transactions where it is very clear that taxes were viewed by the parties as being a very significant inducing factor.

You are going to hear testimony later in these hearings from participants in these acquisitions and their advisers, and I think

they will give you some insight into what their planning is and to what extent they view taxes to be a motivating factor.

One example that does come to mind is the attempted acquisition of Gulf Oil by Mr. Pickens. In that situation, Mr. Pickens planned that transaction to take the control of Gulf Oil in order to have a royalty trust spun out. His announced purpose, and I believe he was correct in his analysis of the situation, was to take the oil reserves of Gulf, or a significant portion, and move them out of corporate solution, eliminate the potential double tax in the tax system, and——

Mr. FLIPPO. All I am trying to do is to establish whether or not there has been a conclusive study on that point that we could refer to, that you are aware of.

Mr. BROCKWAY. Well, in our pamphlet on page 13, we cite a study that takes the position that tax factors were a major force in some one-fourth of the transactions. Whether or not that study is correct is difficult to tell.

Mr. FLIPPO. I thank the gentleman. I realize the difficulty of responding to the question.

Thank you for your response.

Thank you, Mr. Chairman.

Mr. BROCKWAY. As I say, in the Gulf Oil transaction taxes clearly were a primary factor that started the ball rolling and ending up in the ultimate acquisition of Gulf Oil by Standard Oil of California. There are also a number of other transactions one could cite where the tax planning drove the transactions, particularly those involving loss companies; transactions facilitating the use or losses of other tax benefits that currently aren't usable by one of the two parties.

However, in addition to transactions such as these where it is clear that the players themselves viewed taxes to be a major driving force, I think there are probably a number of situations where the tax laws, in fact, influence mergers in a way that perhaps aren't consciously recognized by the parties involved.

Many of the transactions that we see occurring right now are ones where the aggregate value of the assets held by the acquired corporations is greater than the aggregate value of the stock outstanding. There are a number of reasons why that difference in values might occur; but at least one reason is the double tax imposed on corporate profits.

To the extent that the double tax causes a lower market value for the outstanding stock of a corporation than its underlying assets, it will tend to create a bias toward an acquisition of the corporation; whether or not the potential acquirer understands that the Tax Code is the cause of that effect isn't so important. It is sufficient that it does have that effect and the potential players observe that differential in price. Observing the differential, they will act to take advantage of it without necessarily understanding its cause.

The typical acquisition does in fact operate through debt financing to eliminate partially that difference in value between outstanding aggregate stock and the underlying assets.

This effect of heavy debt capitalization is one example of the fact that, for the most part, the tax rules that tend to operate to influ-

ence mergers and acquisitions really are part of the fundamental rules of our system of taxing corporate income.

So even if you come to the conclusion that the tax laws do in fact operate to induce some of the transactions that are taking place, it may well be that, having considered the changes you would have to make in the fundamental rules of taxing corporate income in order to eliminate those distorting effects, you will come to the conclusion that you would prefer the current tax system rather than the alternative.

I think that the most important issue in this regard is the treatment of debt. I have a table that has been handed out, table 1, where I try to outline the different results from debt and equity capitalization of a corporation.

In that example, there are two corporations, corporation A and B, each having $1,000 of assets yielding $100 of taxable income. Corporation A is taxed at a 46-percent rate on the $100 that it earns on its equity capitalization. It has $54 left over for distribution to its equity investors.

Corporation B, and this is an assumption contrary to fact, is 100-percent debt financed and distributes all its earning out as interest, and thus there is no corporate tax. In the case of corporation A, the equity financed corporation, the net effect if it distributes all its after tax earnings to its shareholders as dividends is that there is a tax of up to $73, or an aggregate 73 percent effective rate of tax; that is, there would be a $46 corporate tax and a $27 tax on the $54 distributed as a dividend. In contrast, there would only be an aggregate 50-percent tax on the interest distribution by corporation B.

If you accept the premise that investors generally will be seeking similar yields on their investments, in this example I have assumed that everybody in the economy wants to generate at least a 10-percent yield on their assets, then the assets in this case are worth $1,000 to the corporation and the debt is worth $1,000. However, since there is the corporate tax burden of 46 percent, then, ignoring all other factors, the stock in the corporation A should only be traded at $540 to reflect the corporate tax burden.

Now, this is an oversimplified example where there is 100-percent debt capitalization. In fact, even if a corporation was solely tax motivated, it would not attempt to reach 100 percent debt capitalization. For one reason, that would not be permitted under the general principles of the tax laws regarding debt and equity. For another, there is no particular tax reason for a corporation to convert its capitalization into debt financing beyond the extent necessary to eliminate its tax liability. Under our substantive tax rules, it is, of course, frequently easy for a corporation not to be taxed fully on all its economic income. If a corporation were to be solely tax motivated, it would attempt to finance debt only to the extent necessary to shelter itself fully against corporate tax.

Given that strong bias toward debt financing in the tax system, it is likely to encourage corporations to have a much higher debt-to-equity ratio than would otherwise be optimal. There are several ways they might attempt to go about reaching that higher debt to equity ratio.

The simplest way for a corporation to replace its existing equity capitalization with debt capitalization is for the corporation to buy back some of its stock, replacing enough equity with debt so that the interest payments fully shelter the corporate tax.

While this approach is relatively simple and easy for a corporation, corporate management may frequently be reluctant to pursue this strategy as aggressively as it might solely for tax purposes, because of the erosion in the equity base.

Having said that, there are indications that in recent years there has been a significant increase in the extent that corporations have been repurchasing their outstanding stock.

And if you ignore all other factors, which, in fact, may be far more significant, such stock repurchases should increase the rate of return on the remaining equity, and therefore its market value, in that they increase the proportion of rate of return on the remaining equity that is derived from investments that are not fully taxable to the corporation.

If management of the corporation does not choose to engage in a stock repurchase approach on the open market or through redemption, another approach that is available to the corporation that appears to have increased in recent years is a leveraged buyout. This transaction is essentially the same as the debt financed stock repurchase program, but almost all the stock is replaced by debt issued in connection with a tender offer rather than just a relatively small portion of the equity being replaced on a gradual basis. And generally part of the acquiring group is the existing management of the corporation, who then have an opportunity to participate in some of the appreciation in value in the stock that would result from this elimination of the corporate tax.

It is very clear, whether or not they are thinking about the tax issues in the leveraged buyout transaction, the effect of using debt financing and eliminating the corporate tax does increase the return on the equity investment in the corporation. One possible view of this is that the Treasury Department, through the tax reduction resulting from the replacement of the equity with the debt, is helping to finance the leveraged buyout, helping to finance the repurchase of the shares. Arguably, the Treasury is providing the differential that is needed to finance the transaction.

A third way in which this bias for replacing equity with debt financing can be implemented is for a currently taxable corporation to acquire another corporation. This could be through either a friendly acquisition or a hostile acquisition; I don't think that the effect debt really makes much difference in that regard.

If you look at the two corporations in the aggregate, to the extent the transaction is financed by debt, and heavy debt financing has been the typical pattern, there is a larger amount of debt outstanding after the transaction is over and a corresponding reduction in equity. As in the case of the leveraged buyout, one might view the reduction in corporate tax stemming from this increased debt capitalization as helping to finance the acquisition, whether friendly or hostile.

The existing management of a corporation may frequently refrain from exploiting to the extreme the potential tax reduction involved in aggressively leveraging the corporation to the extent nec-

essary to eliminate the corporate tax. As I discussed earlier, the market value of the stock of the corporation might therefore trade at a value less than the underlying assets. In this situation, an outside group of investors who perhaps are less conservative in outlook or, for one reason or another, have some less significant concern about the increasing of the risk of the corporation, might attempt to take advantage of this differential in price resulting from the tax system and attempt a leveraged takeover.

In addition to this general problem created by the double taxation of equity and the single taxation of debt, a similar distortion arises in the difference in taxation of dividends as ordinary income and the taxation as capital gains of stock repurchases, whether effected on the open market or by a redemption or liquidation.

This difference again creates a tax bias against dividend payouts and toward stock repurchases. In most situations a corporation for nontax reasons will not wish to adopt a policy of refraining totally from paying out ordinary dividends in the regular course, distributing its earnings instead through stock buy back or redemption program. Again, however, if the corporation decides not to take advantage of this approach, this tax benefit might simply be captured by an outside acquiring group that is using equity capital to finance the takeover. That is, the acquiring corporation, rather than distributing its earnings as dividends taxable at ordinary income rates, accumulates its earnings and uses them to acquire the stock of another corporation.

Again, as result of the takeover, viewed in the aggregate, dividend payouts, taxable as ordinary income are reduced and they are replaced with a repurchase of stock from the taxed company shareholders taxable as capital gains.

In order to eliminate the distortions resulting from the significant differences in the tax treatment of debt and equity and of dividends and stock repurchases, it would be necessary to change radically the taxation of corporate income. It is not at all clear, as I said earlier, that even if you accept the fact that the corporate tax system does create these distortions, that you would wish to undertake the changes that might be necessary to eliminate them.

The most important thing that would have to be done if you were to eliminate these distortions that arise from the current tax system is to move to a full integration of the corporate tax, a regime in which there would only be a single tax imposed on corporate earnings, whether distributed with respect to equity or with respect to debt.

The complete elimination of these biases would also involve basis adjustments by the shareholders to reflect retained corporate earnings and various other fairly complicated changes. And if you didn't make significant compensating changes, but simply allowed, for example, 100-percent divided paid deduction, there would be a fairly substantial revenue cost.

It would also be necessary to eliminate the differential capital gains and ordinary income to eliminate any tax bias in favor of corporate acquisitions. You would also have to ensure that corporations are taxed currently on their economic income, and in particular that they are taxed on distributions of appreciated assets in liquidations and acquisitions.

I should point out in this context that the Treasury comprehensive tax reform proposals do move in part in some of these directions, and if you were to enact the Treasury proposals, the incentives existing in present law toward mergers and acquisitions would be mitigated somewhat.

There are a variety of other much more limited changes you might wish to make that would reduce somewhat the incentives in the present tax system to increase debt capitalization, if you did not feel you could move to a fully integrated tax system.

One of the points that you and others discussed earlier, Mr. Flippo, was whether you could come up with a system that discouraged acquisition indebtedness but did not attempt to differentiate between hostile and friendly takeovers. While we have not completed our analysis of this issue, our initial reaction is that it may not be possible to do so satisfactorily because there is no clear answer to the question of how you would differentiate between debt incurred in connection with an acquisition and other debt, particularly with the passage of time and subsequent refinancing and other transactions.

If you thought the problem was not limited to acquisition debt but rather was the differential between the taxation of debt and equity generally, you might consider proposals to limit to some extent the amount of interest that may be deducted by publicly traded corporations whose debt capitalization is excessive.

Under this type of limitation, a potential acquirer would not have a great deal more opportunity than the existing management to eliminate the corporate tax totally through excessive debt capitalization. Whether some limitation of this type is on balance a good idea or not, I am not prepared to say at the moment, but it is something we are looking into along with some of the other more narrowly focused approaches.

I have another table that outlines the differences in the treatment of various types of corporate acquisitions. This is covered in some detail in our pamphlet.

In the interest of time, I will not try to go through all these transactions in depth. To summarize, it is very clear that, depending upon how a corporate acquisition is structured, the tax results may change fairly dramatically, and the taxpayers in most of these cases have their option as to how to structure the transaction to achieve the most favorable results.

Also, in a number of these cases, the taxpayers may be able to structure the transaction so that there is a greater tax benefit in going forward with the transaction than if the transaction had not occurred. The effects swing all the way from the taxable acquisition of assets in the ordinary course of business where the income or loss is taxed to the corporation on sale of assets and the profits are distributed and taxed as ordinary income to shareholders to situations involving a complete step up to the buyer without the seller recognizing the full gain on the transaction.

In this latter type of transaction under certain factual circumstances the parties may be better off going through the transaction than not because there is a higher basis to the buyer after the end of the transaction which they can use to compute their depreciation or other tax benefits from even though that basis step-up is

not compensated for with complete recognition of gain by the seller.

That can happen, for example, in a liquidation followed by a sale of the assets, a sale of the assets followed by a liquidation, neither of which are hostile takeover situations, or in a hostile or friendly takeover situation where there is a sale of all the stock of the corporation or most of the stock of a corporation within a defined period of time and an election by the buyer to treat it as if it purchased the assets rather than the stock, so that each side of the transaction gets to choose its more favorable treatment.

A third structure used is the purchase of the stock of the target corporation without electing to treat it as a deemed liquidation. There may be a capital gain to the selling shareholders, but all the corporate attributes survive in the hands of the new buyer. There are a number of situations where you might find this treatment as creating an inducement to structure the sale of the assets in this form rather than in a direct sale of assets.

One example is where one of the two parties has unusable tax benefits. In one type of case, a loss company might buy the stock of the target corporation and the selling shareholders recognize only a capital gain but any inside, built-in gain and any inside recapture income of the target corporation would be recognized by the loss company who would not suffer tax on it.

Alternately you might have a situation where a taxable corporation acquires the stock of a loss corporation, keeps it intact as a subsidiary and then, assuming that it can successfully negotiate itself around the current rules dealing with trafficking in net operating losses and excess credits, it might be able to take advantage of some or all of the currently unusable deductions and credits of the loss company.

The final type of transaction that might effectively involve the transfer of all the assets of a corporation is a tax-free reorganization where there is an exchange of stock in the target company for at least in part stock of the acquiring corporation. In that situation, to the extent there has been a stock for stock exchange the exchanging shareholders do not, as a general matter, recognize any tax on the transfer. They merely get a substitute basis in their stock, the same basis in the the stock of the purchasing corporation that they had in the stock of the target corporation.

And again, in that situation at the corporate level, it is generally treated as if no transaction had occurred. With limited exceptions, the tax attributes of the acquired corporation survive.

Whether or not this treatment is troublesome in part depends upon the relative size of the parties. Where the parties are roughly equivalent in size, it does not appear that the shareholders really have changed their positions much by going through the transaction.

Where the target corporation is much smaller than the acquired corporation, it is not so clear that the transaction does not significantly alter the position of the target corporation's shareholders. If you have a situation where the acquiring corporation is 99 times the size of the target corporation and after the transaction is over the target corporation's shareholders have only a 1-percent interest in the surviving entity, it seems that an argument might be made

that there is a significant change in ownership at that point and perhaps the transaction is much more analogous to the earlier transactions involving a sale of the corporation.

Beyond those general rules involving the taxation of mergers and acquisitions, there are a number of specific areas that we can go into if you would like, involving, for example, greenmail or the taxation of pension plans and ESOP's.

With that, I will conclude my remarks.

[The following prepared statement was subsequently received:]

STATEMENT OF DAVID H. BROCKWAY, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

I. INTRODUCTION

My remarks are intended to give an overview of the tax treatment of mergers and acquisitions and the policy issues involved. I would like to submit for the record the pamphlet prepared by the Joint Committee staff for the hearings which discusses these issues in much greater depth.[1]

To begin with, the treatment of mergers and acquisitions is one of the more complex and difficult areas of the tax law and the tax issues involved are almost unlimited. In most cases, there are several different forms in which a transaction can be structured, each achieving a similar substantive result from a nontax standpoint but with significantly different treatment for tax purposes. The relative tax advantages and disadvantages of the various forms vary greatly depending upon the particular facts of each situation. It is, therefore, extremely difficult to put this subject in an easily digested, coherent framework, and my remarks are not intended as an exhaustive treatment of the subject. I will pass over many important issues and points.

I wish to emphasize at the outset my belief that mergers and acquisitions are largely driven by nontax factors. Since my remarks are directed only at the tax aspects of this topic, they may seem to imply a more significant role for taxes than is realistic. I do not intend to suggest that taxes are a primary factor in all or most cases. They are, however, a factor in most transactions, and a primary factor in a few. It appears clear to me that the tax law does operate to drive some transactions that would not otherwise occur and in many others drives the form in which they occur.

As a general rule, mergers and acquisitions, like most other business investments, are analyzed by the participants on the basis of financial projections computed on an after-tax basis. Particularly in leveraged acquisitions, the tax impacts are significant. A number of articles and conversations with experts in the field indicate that the participants generally are very conscious of the tax implications in deciding whether to go forward with a transaction and how to structure it. In some transactions, the participants have freely acknowledged that the tax laws were a major factor in the decision to go forward.

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[1] The pamphlet was coordinated by Jack Sterling and prepared by Jack, Elaine Church, Jim Dring, Paul Jacokes, Mary Levontin, Peter Merrill, and LaBrenda Stodghill.

Even if the participants are not conscious of the implications of the tax laws, these tax laws may nevertheless influence their actions. For example, many mergers and acquisitions now take place because the assets of the target companies are worth more than the aggregate value of their outstanding stock. The reasons for this are many, but, as discussed below, one important reason may be the double tax on corporate profits. The acquirers act because they see the price differential without necessarily analyzing the reason for it. As typically structured with substantial leverage, acquisitions generally reduce or eliminate that differential caused by the tax system.

While I do believe that the corporate tax system does create a significant bias in favor of acquisitions in certain circumstances, there is no smoking gun--no single provision that causes inefficient mergers or acquisitions to happen. In large part, the tax rules that operate to distort the natural operation of the economy and serve to influence and induce those transactions are fundamental rules of our system of taxing corporate income rather than rules dealing specifically with mergers and acquisitions. The impacts of these fundamental rules are discussed in Part II of this testimony. Even if you conclude that these rules have the undesirable effect of inducing these transactions, it is very possible that you may conclude that the changes required to eliminate these distortions would be sufficiently radical or otherwise undesirable that you would not want to enact them even if doing so were the only way to eliminate these undesirable effects. For that reason, this testimony explores some less ambitious options. It is an unfortunate truism, however, that the less controversial the proposed change, the less likely it will be particularly effective.

Obviously the tax rules governing the various types of merger and acquisition transactions also directly affect these transactions. These rules are discussed in Part III of this testimony. Again, it appears reasonably clear that in some cases current tax law creates certain biases that favor these transactions. Although not as far reaching as certain of the more ambitious options outlined in Part II, the changes that might be appropriate to eliminate these distortions are themselves significant and hardly free from controversy.

I have not attempted here to cover the many narrower issues relating to the taxation of mergers and acquisitions--greenmail, the use of ESOPs, installment sales, the allocation of interest incurred in an acquisition between U.S. and foreign sources, etc. A number of these issues and possible legislative reactions to them are discussed in the staff pamphlet.

Before discussing the tax consequences under present law of mergers and acquisitions and related transactions, I would like to make a few observations about the tax policy objectives that might be pursued in this area. There appears to be general agreement that one appropriate policy goal is that the tax law should not provide benefits that would not be available in the absence of a transaction and, in particular, should not distort the economy by providing incentives for taxpayers to enter into transactions that would not otherwise occur. Conversely, while policy makers might, for nontax reasons, wish to discourage certain types of transactions through the tax system (as Congress decided last year in the case of "golden parachute" arrangements or as some propose now with respect to "greenmail" payments), many observers also argue that the tax treatment of mergers and acquisitions should not provide artificial disincentives to these transactions. That is, the tax laws should be neutral, neither encouraging nor discouraging mergers and acquisitions.

Nevertheless, it should be understood that complete elimination of all incentives and disincentives for mergers and acquisitions created by the tax system, even if the ideal, would not be possible. To the extent the tax system departs from a theoretically pure lump sum tax that does not vary according to taxpayers' behavior, it will inevitably have significant distorting effects on the economy. Since such departures are a necessary characteristic of our tax system, the goal of neutrality may be best achieved by conforming the impacts of the merger and acquisition rules with the unavoidable distortions caused by the general tax rules. For example, under an income tax, for cash flow, valuation, and other reasons, appreciation or depreciation in the value of an asset is generally not taxed until realized upon a disposition of the asset. By taxing gain only upon realization, the tax law generally builds in a bias against transfers of appreciated assets and in favor of transfers of assets that would generate tax losses. Since in many cases mergers and acquisitions essentially are the equivalent of the taxable transfers of assets that otherwise might occur, the appropriate tax policy objective in some cases arguably might be, absent other considerations, to reach the same results (and the same biases) that the functionally equivalent taxable transactions would involve. Otherwise, the tax system might artificially induce mergers and acquisitions in lieu of ordinary business transactions. Thus, while there may be some agreement that the policy objective should be neutrality, it is not always clear what neutrality is.

II. INCENTIVES FOR CORPORATE ACQUISITIONS CREATED BY THE GENERAL SYSTEM OF TAXING CORPORATIONS

Under our present corporate tax system, the tax burden on the earnings of a corporation varies widely depending upon how and when those earnings are returned to the investors in that corporation and the types of activities from which those earnings are derived. In this part, I shall attempt to outline some of these major differences in the taxation of corporate earnings and how they might operate to influence and induce mergers, acquisitions, and related transactions.

A. Tax Advantages of Replacing Equity With Debt

Since our corporate tax system provides no dividends paid deduction or similar relief, there is, as a general rule, a double tax on dividends received by individual U.S. stockholders--assuming the dividends are derived from profits taxed at the corporate level and the individual shareholder does not enter into some other transaction to avoid the tax. In contrast, to the extent the corporation is debt financed and the return on its investments are distributed to its investors as interest, there is no tax imposed at the corporate level. Thus, a distribution in the form of a dividend from a corporation taxable at the top corporate rate of 46 percent to an individual shareholder taxable at the top individual rate of 50 percent would be subject to a combined tax of 73 percent (46 percent at the corporate level and 27 percent at the shareholder level--50 percent of the 54 percent remaining for distribution after the corporate level tax). In contrast, earnings on investments by that corporation that are distributed as interest would be subject to no corporate level tax, in general leaving the full return on its investment of debt capital to be distributed and subject only to a 50-percent tax at the individual investor level. (This point is illustrated in Example 1, below.) Similarly, if the investor were in a low bracket, a tax-exempt entity for example, a wide differential also exists; in this case a tax of 46 percent on dividends and a zero tax on interest.

Example 1

The difference in the tax treatment of debt and equity financing may be illustrated by the following oversimplified set of facts. Assume that Corporation A is 100-percent equity financed, Corporation B is 100-percent debt financed (at a 10-percent interest rate), and each holds assets of $1,000 that earn $100 a year. In this illustration, corporate taxable income is taxed at a flat 46-percent rate and all stockholders and bondholders are taxed at a flat 50-percent rate. All earnings are distributed. The tax consequences would be as follows:

	Corporation A	Corporation B
1. Operating income	$100	$100
2. Interest expense	-0-	(100)
3. Taxable income	100	-0-
4. Corporate tax	(46)	-0-
5. Return to investors	54	100
6. Pre-tax rate of return to investors	5.4%	10%
7. Individual tax	27 (50% x 54)	50
8. Aggregate tax	73 (46 + 27)	50
9. After tax return to investors	2.7%	5%

The existence of this wide differential in the taxation of investments made through corporations obviously creates a strong bias in favor of debt financing. As discussed in the next section, however, the relative disadvantage of equity financing is reduced somewhat if the earnings are not currently returned to the equity investors as dividends but rather are retained and reinvested or are returned to the equity investors through a repurchase of some or all of their equity investments.

The deductibility of interest does not operate as an incentive to 100-percent debt finance, but only as an incentive to debt finance to the extent necessary to eliminate the corporate tax. Under the current substantive tax rules, other than those relating to the deductibility of interest, a significant portion of the yield received by corporations on their investments is not currently subject to tax. Thus, to the extent that corporate income is otherwise not subject to tax, the deduction for interest paid on debt financing provides no advantage for debt financing over equity financing. (See Example 2, below.) Indeed, there are

some factors that might provide a bias toward equity financing once the corporate tax burden has been fully sheltered.[2]

Example 2

Assume that the facts of Example 1 are modified so that Corporations A and B each have assets of $2,000 that earn $200 a year--comprised of $100 of income that is fully taxable and $100 of income that is fully sheltered by preferential treatment. Corporation A is again entirely equity capitalized while Corporation B is half equity and half debt capitalized. The tax consequences are as follows:

	Corporation A	Corporation B
1. Operating income	$200	$200
2. Less (a) tax preferences	(100)	(100)
(b) interest expense	-0-	(100)
3. Taxable income	100	-0-
4. Corporate tax	46	-0-
5. Return to investors	154	200
6. Pre-tax rate of return to investor	7.7%	10%

Thus, the corporate tax liability of Corporation B is eliminated by replacing half its equity with debt, increasing the rate of return on the equity (and thus its market value) from 7.7 percent to 10 percent, reflecting the fact that the entire return on equity is derived from tax preferred income. Any additional debt financing would generate interest deductions that are not currently useable.

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[2] Obviously, interest deductions creating net operating losses are valuable to the extent tax liability will exist in other years that can be reduced by the carryover of those losses. Aside from the possible use of loss carryovers, however, retention and reinvestment of profits or stock repurchases may be preferable from a tax standpoint to interest payments that are currently taxable in full to the lender. Moreover, a "fully sheltered" corporation may often find it cheaper to raise funds by issuing preferred stock (which can be structured to mimic almost exactly the nontax substantive characteristics of debt) rather than debt because the interest deduction would not be usable currently while the dividend payments would qualify for the 85-percent dividends received deduction in the hands of corporate holders of the preferred stock. A portion of the benefit of the dividends received deduction is passed back to the issuing corporation because the corporate holders demand a lower dividend rate than they would require on fully taxable interest.

Subject to these caveats, the corporate tax system does have a bias in favor of debt finance.[3] That being the case, the tax system is likely to encourage corporations to have a higher debt to equity ratio than they would have absent the impact of the tax system. There are several ways that corporations that are currently paying, and expect to continue to pay, a significant amount of tax can replace some of their equity with debt and thus increase the after-tax rate of return to their equity investors.

The simplest way is for the corporation to borrow money and use it to buy back some of its outstanding stock, replacing enough equity with debt so that the interest payments shelter the corporation's income from tax. Although this approach is relatively simple, corporate management is frequently reluctant to pursue this strategy aggressively because of the increase in financial risk to the corporation resulting from the erosion of its equity base. Nevertheless, there are indications that corporations have undertaken an increasing amount of stock repurchases in recent years. Ignoring nontax factors (which may, in fact, be far more significant), a currently taxable corporation that repurchases its stock using borrowed funds could increase the rate of return on the remaining equity, and thus its market value, since the cost of debt financing (net of the tax benefit of interest deductibility) is in many cases less than the cost of the equity it replaces.

A variation on this approach, the use of which has increased dramatically in recent years, is the leveraged buy

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[3] In addition to the deductibility of interest, debt financing can prove advantageous, particularly for closely held companies, because the principal repayments, while nondeductible, are not includible in the income of the lender even where the repayments are pro rata to shareholders. Also, hybrid securities (or tandem debt and equity interests) can be structured so that any gain on the investment will be attributed to the equity feature, and thus capital in nature, while any loss on the investment will be realized as a partial or complete bad debt loss on the debt feature, and thus ordinary in nature--somewhat of a heads I win, tails you lose arrangement. Typically, the lenders in leveraged buy outs and acquisitions take substantial equity interests in the target company in the form of warrants, conversion features, or otherwise so that they can participate in the potential upside. (This type of financial structure is frequently also used by outside investors providing venture capital to start-up enterprises.) The more highly leveraged the target company is, the larger the portion of the loss, if any, on the investment that will be treated as ordinary.

out. This transaction is essentially the same as a stock repurchase program--almost all the stock is replaced by debt with the remaining equity held by a relatively small group of investors (typically including the corporate managers). This can be accomplished by a debt-financed tender offer by the existing corporation for its outstanding publicly held stock, or, alternatively, by a tender offer for the target corporation's stock made by a largely debt-financed shell corporation established for this purpose. Again, it is not clear to what extent, if any, the increase in leveraged buy outs in recent years has been influenced by tax considerations, but it is clear that the debt incurred in a typical leveraged buy out significantly reduces or even eliminates any corporate tax burden borne by the corporation prior to the transaction. This tax reduction would, of course, be an element of value that helps pay the typical premium of the price offered in the tender offer. From this perspective, the Treasury may be viewed as financing, in part, leveraged buy outs.

A third impact of the bias for currently taxable corporations to replace equity with debt financing is the encouraging of the acquisition of one corporation by another--whether through a friendly acquisition or a hostile takeover. To the extent that the acquisition of the target company is financed with debt, the aggregate debt capitalization of the two corporations is increased and the aggregate outstanding equity financing is decreased. The acquisition serves to reduce the aggregate corporate tax paid by the two parties compared to what would have been paid in the absence of the transaction. Again, the Treasury, as the result of this reduction in the aggregate tax burden, may be viewed as financing and inducing the takeover.

Since existing management may frequently refrain from exploiting to the extreme the tax advantages inherent in replacing equity with debt, the market price of the stock may trade at an aggregate price lower than the market value of the corporation's assets--reflecting the burden of the corporate tax. This may be illustrated by reference to Example 1, above. If it is assumed that all investors in the economy demand the same risk adjusted rate of return, say 10 percent before tax, then the assets held by Corporations A and B that earn $100 have a market value of $1,000. As a result of the corporate tax burden on the earnings of corporation A, however, the annual return to its investors is only $54 and, thus, the market value of its stock would only be $540 (ignoring all other factors). This differential may operate to induce attempts to take over corporations like Corporation A in order to capture the benefits of avoiding the corporate tax through debt capitalization. The potential purchasers may, for example, be more willing to increase the debt to equity ratio than existing management because as

outsiders they have less concern about the long-term viability of the company.

An additional tax benefit can be secured if the selling shareholders supply the debt incurred to replace the outstanding equity. Whether the transaction is a stock repurchase program, a leveraged buy out, or an acquisition of one corporation by another, it can be structured as an installment sale of the stock. The issuing corporation secures the benefit of deductible interest payments and the selling shareholders defer the tax on any gain on their sale of stock until the principal of the notes is paid.[4]

B. Tax Advantages of Retained Profits, Stock Repurchases and Corporate Acquisitions Over Dividend Distributions

Depending upon when and how the return on equity investments is realized by shareholders, wide differences in effective tax rates, and presumably significant distortions in the market place, also exist under our current system. If corporate earnings are distributed to individual shareholders as dividends, the dividends are taxed at rates of up to 50 percent. The shareholders may then reinvest the after-tax

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[4] With some creative tax planning, it may even be possible to secure the deferral benefits of installment sale treatment where the acquiring corporation is making a cash tender offer. In the acquisition of Gulf Oil by Socal, for example, Socal made a cash tender offer. Mesa Petroleum held its considerable block of appreciated Gulf stock through a subsidiary holding company whose only asset was the Gulf stock. Mesa Petroleum did not, however, tender its stock directly to Socal. Instead, Mesa deferred its gain by selling the subsidiary on an installment basis to Penn Central (assuming the form of the transaction will be respected for tax purposes). The subsidiary tendered the Gulf stock to Socal shortly after the transaction. Even if it did not attempt to avoid tax on its newly acquired subsidiary's disposition of the Gulf stock by making a section 338 election (discussed in Part III), Penn Central had large net operating losses available to shelter its newly acquired subsidiary's gain on the Gulf stock. Another advantage of this structure is that it permitted Mesa to claim long-term capital gain on the disposition of the holding company stock (which it had held as a shell corporation prior to acquiring the Gulf stock) rather than the short-term capital gain that it would have had to claim if it tendered the Gulf stock directly. See the discussion of built-in gains and losses in Part III.

yield. Other more tax advantaged approaches are available, however. One such approach is for the corporation to retain and reinvest its profits, and its stock should appreciate in value to reflect the retained profit. The shareholder tax is thus deferred until the retained profits are subsequently distributed or the shareholder disposes of his stock. In the latter case, a lower capital gains tax generally applies. This relatively favorable treatment of retained profits presumably inflates stock prices somewhat and creates some market pressure on corporations to retain and reinvest profits to an extent greater than they would in the absence of a tax system.

This tax incentive for a corporation to retain and reinvest its earnings does not necessarily have to be satisfied by internal expansion of its existing business. The corporation may instead respond to this favorable treatment of retained earnings by using those accumulated earnings to acquire another corporation. In addition, the retention of funds and the resultant strengthening of the balance sheet may well serve to make the corporation a more attractive takeover target.

An alternative method for a corporation to distribute its return on equity to its individual shareholders at a lower shareholder tax than that applicable to a dividend would be for the corporation to distribute that return through the repurchase (subject to certain limitations) of some of its outstanding stock. Thus, where the gain on the stock repurchase qualified for long-term capital gain treatment, the individual shareholder would be taxed at a maximum rate of 20 percent of the gain instead of a 50-percent tax on the full amount of the distribution.[5] Moreover, only the shareholder's gain would be subject to tax rather than the entire distribution. (Similarly, if the corporation is not currently taxable and thus unable to derive full benefit from its interest deductions, it might opt to repay some of its debt rather than distribute a dividend taxable to its shareholders.)

The polar case of this approach is the distribution by a corporation of its assets in a complete liquidation. Not only is the distribution of profits in this manner treated like a sale of the corporation's stock by its shareholders

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[5] Returning earnings in this fashion rather than as dividends is disadvantageous to corporate shareholders because of the 85-percent corporate dividends received deduction. It might also be unattractive to nontaxable investors because the additional transaction costs would not be compensated for through tax savings. If so desired, the needs of these shareholders can be responded to by issuing more than one class of stock.

resulting in capital gain treatment at the shareholder level (sec. 331), but it also is tax preferred at the corporate level. Under the rules governing corporate liquidations (sec. 336), corporate tax generally can be avoided permanently on unrealized appreciation and certain other income accrued by the corporation but not yet taxed (referred to as the General Utilities[6] doctrine). The shareholders are taxed on the gain (if any), computed as if they had sold their stock for the proceeds they receive in liquidation.[7]

While this strategy of distributing corporate earnings by repurchasing stock (through open market purchases, redemption, liquidation, or otherwise) rather than distributing dividends is tax favored, corporations do not fully exploit this tax advantage for a number of nontax reasons. As in the case of debt financed stock repurchases, however, another approach exists that effectively operates to achieve this tax preferred result--the acquisition, hostile or friendly, of one corporation by another. Rather than distributing its profits as taxable dividends, a corporation might choose to retain its profits and acquire the stock of another corporation. The target corporation's shareholders receive capital gains while the shareholders of the acquiring corporation receive their return in the form of appreciation in stock prices due to the retention of profits. Between the two corporations in the aggregate, the payment of dividends taxable as ordinary income has been replaced by a purchase of stock taxable at capital gains rates. Moreover, as discussed in a following section, in some cases the purchaser can elect to treat the transaction as a liquidation of the acquired corporation with the permanent avoidance of corporate level tax on some income. (Where that treatment is available, it is advantageous from a tax standpoint if the present value of the deferred tax saving that would result from the basis step-up exceeds the present recapture taxes paid on the deemed liquidation.)

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[6] General Utilities and Operating Co. v. Helvering, 296 U.S. 200 (1935).

[7] The business could be continued in corporate form by reincorporating the capital, the shareholders retaining the profits. In addition to the obvious nontax problems that discourage this practice, the reorganization provisions and liquidation/reincorporation doctrine of the present tax law would ordinarily operate to treat the distributed profits as a dividend where the shareholders of the old corporation had a significant ownership interest in the new corporation.

C. Tax Advantages of Combining High-Tax and Low-Tax Activities

In our existing high rate, high preference system of taxing business income, effective tax rates vary widely from activity to activity. Those activities with few preferences may have effective tax rates approaching the statutory 46-percent top corporate rate while heavily preferred activities, particularly when debt financed, frequently generate tax deductions and credits that are more than sufficient to eliminate any current tax liability. Any such excess tax benefits are obviously worth more where they can be used currently used to offset tax liability from other higher tax activities of the corporation (or of affiliated corporations with which it files a consolidated return). Consequently, investments in such tax preferred activities generate higher after-tax rates of return, and are worth more, if combined with other investments against which the excess tax benefits generated by the preferred activity can be used currently. Corporations that have generated, and expect to generate, substantial tax liability from their existing activities thus may view businesses that can be expected to generate excess tax benefits as attractive takeover targets, and vice versa. Moreover, as pre-tax yields on investments in tax preferred activities drop to reflect the investment attracted by the current use of excess tax benefits against unrelated investments, it becomes increasingly difficult for unaffiliated businesses that operate only in that tax preferred activity to compete effectively.

Like other tax factors discussed in this testimony, it is difficult to determine how significant the tax benefit resulting from the combination of high and low tax operations is in motivating merger and acquisition activity. Some observers maintain, for example, that this has been one of the dominant factors in the merger and acquisition activity involving property and casualty insurance companies--which under current law typically generate significant excess tax benefits. A similar pattern may well exist in other tax-preferred activities. On an anecdotal basis, there have been a number of cases where this tax consideration was reported to be one of the significant factors taken into account by the acquiring company. Whether or not the available evidence is sufficient to cause great concern, it is clear that the potential value of combining low and high tax activities is significant and available to be tapped through corporate mergers and acquisitions.

D. Possible legislative changes to reduce acquisition incentives

There are a variety of approaches that might be taken to reduce the current incentives for corporate acquisitions created by the general system of taxing corporations discussed above. These approaches range from a comprehensive restructuring of corporate taxation, which would be most effective but would have consequences extending far beyond corporate acquisitions, to limitations on acquisition indebtedness, more narrowly focused but less likely to be particularly effective.

Comprehensive tax reform.--In order to eliminate the distortions inherent in present law, it would be necessary to change the taxation of corporate income radically. Indeed, the required changes might very well involve consequences that Congress would view, on balance, as being far more undesirable than the distortions caused by present law.

The change in our general system of corporate taxation that probably would do most to eliminate these distortions would be the full integration of corporate and shareholder taxation, leaving only a single tax on corporate profits whether financed by equity or debt. If debt and equity were thus treated in a similar fashion, the incentive created by the tax system for corporations to substitute debt for equity through debt financed acquisitions would be eliminated.

Another important change would be the taxation of gains on the sale or exchange of corporate stock (including repurchase by the issuing corporation on the open market, by redemption, or in liquidation) at the same rate that dividend and interest income is taxed. The elimination of preferential treatment for capital gains would lessen the relative attractiveness for corporations to retain and reinvest their earnings and for shareholders to secure the return on their investment through the disposition of their stock in corporate acquisitions (or otherwise). Although it would be very complicated to do so in practice, in a fully integrated tax system shareholders would include a proportionate share of a corporation's earnings in income annually and would receive an upwards basis adjustment for earnings retained at the corporate level; such a basis adjustment would offset to some extent the elimination of the capital gains differential.

The third major change necessary to eliminate these distortions would be to replace our current high rate, high preference system of taxing business income with a broad base, low rate system. This shift would reduce the opportunities for reducing taxes by combining high and low

tax activities. Moreover, as a general rule, the lower the marginal rates are, the less powerful any tax bias is. Absent complete corporate/shareholder integration, a comprehensive corporate tax system would include the taxation of distributing corporations on the unrealized appreciation of property distributed to their shareholders in liquidation or otherwise (i.e., the repeal of statutory provisions codifying the the General Utilities doctrine). Among other things, the repeal of the General Utilities doctrine would minimize the tax advantages that currently exist for acquisitions or liquidations of corporations whose assets have substantially appreciated.

It is obvious that these changes raise policy issues that go far beyond the question of whether the tax laws should be revised to reduce their present tendency to distort corporate finance policy and induce merger and acquisition activity that might not occur in a more neutral system. While the impact of the current system on mergers and acquisitions might not be sufficient reason in itself for Congress to move toward any of these policy positions, the same issues also arise in the context of comprehensive tax reform. Accordingly, as Congress considers these and other far reaching proposed changes in its deliberations on comprehensive tax reform, their impact on mergers and acquisitions is an important factor to take into account.

In this regard, it should be noted that the Treasury reform proposals move in the direction of these changes insofar as they allow a partial dividends-paid deduction and move toward a lower rate/broader base system. Thus, the Treasury proposals may reasonably be viewed as tending to reduce somewhat the artificial incentives created by current law for mergers and acquisitions.

Alternative minimum tax.--A corporate alternative minimum tax would operate to reduce certain tax incentives to merge. It would, however, also introduce a new one.

Under an alternative minimum tax regime, the tax incentives for debt financing would be reduced. After a corporation reduced its regular tax, through tax preferences and debt financing, to a point that it became subject to the alternative minimum tax, its marginal incentive to replace equity with debt would be reduced significantly. Debt capitalization results in a regular corporate tax savings of 46 percent of the amount of interest paid. Once the alternative minimum tax "crossover point" is reached, however, the tax savings from debt financing are reduced to the lower alternative minimum tax rate times the amount of any additional interest paid. While it would still be possible for a corporation to eliminate its tax through debt capitalization, its lower marginal tax incentive to incur debt could be outweighed by the nontax factors mitigating

against the increase in leverage at a lower debt to equity ratio. In addition, it would have to incur significantly more debt to eliminate its tax liability--enough to offset the expanded tax base of the alternative minimum tax. Thus, the more comprehensive the base of the minimum tax, the greater its impact in this regard.

In addition to a lower marginal rate and a more comprehensive base than the regular tax, a corporate alternative minimum tax could be designed to tax distributions of appreciated property in liquidation and to make other changes designed to minimize the incentives for tax motivated corporate transactions, even if these changes are not made for purposes of the regular tax.

On the other hand, the minimum tax could create a new incentive for mergers. Just as there is an incentive under the regular corporate tax for corporations with tax losses and excess credits to combine with currently taxable corporations, the alternative minimum tax introduces a similar incentive for corporations continually subject to the alternative minimum tax to merge with corporations that are not. The incentive created by the alternative minimum tax is not as great as that created by the regular tax vis-a-vis a nontaxable firm, since the tax savings are lower. However, the class of taxpayers affected by this incentive (i.e., corporations subject to the alternative minimum tax) may be larger. How powerful this effect is in comparison to the opposite effects, discussed above, of the alternative minimum tax is not clear.

Limitations on excessive debt financing.--A narrower option would be to limit the deductibility of interest in situations where debt financing is considered to be excessive whether or not related to merger or acquisition activity. The objective would be to deny both current management and any potential acquirer the unlimited opportunity to avoid the corporate tax by leveraging the corporation to an extent greater than prudent management might otherwise suggest. An advantage of this type of approach is that it would avoid the not inconsiderable technical difficulties inherent in any attempt to differentiate between acquisition indebtedness, whether or not hostile, and other debt. In addition, the problems created by the bias in favor of debt financing in the current tax system are not limited to excessive debt incurred in the course of the acquisition of one corporation by another.

One disadvantage of this approach is that it is very difficult to draw lines of general application that satisfactorily demark the point at which a corporation's debt financing is excessive. The Treasury's analogous exercise, its attempts over the past 15 years to define the dividing line between debt and equity pursuant to the 1969 legislative

directive of Code section 385, have proven to be not only very complex but also extraordinarily controversial--so much so that the opposition to the proposed regulations from Congress and the business community has been such that it has forced Treasury to revise and liberalize them on more than one occasion. Indeed, even after the revisions, the hostility may still be sufficiently strong that Treasury will opt to drop the effort entirely. In good part, this opposition seems to spring from closely held businesses using shareholder held debt as a form of self-help corporate/shareholder integration. In view of the history in this area, it might be advisable to limit any such restrictions on the deductibility of interest on excessive debt capitalization to large corporations. Even if applicable only to large corporations, it may prove difficult to draw the limits on debt capitalization tight enough in the typical case to discourage excessive leverage without being so tight as to disallow interest deductions in a significant minority of cases where, because of their peculiar circumstances, the indebtedness did not exceed excessive levels. Moreover, in our current high preference tax system the debt needed to shelter the corporate tax fully is frequently well within the most conservative bounds of a sound capital structure.

An alternative approach of general application to discourage excessive debt financing would be to impose a limitation on interest deductions similar to the limitation currently imposed on the investment tax credit. The investment tax credit can be used to offset the first $25,000 of pre-credit tax in full, but then only 85 percent of any pre-credit tax in excess of that amount. Any excess credits are carried over. Following that model, a limitation could be imposed on the deduction of net interest expenses (the excess of interest expenses over interest income), allowing deductions in full up to some floor, for example, the first $50,000 or $100,000 of taxable income (computed without reference to the net interest expenses), and then allowing deductions only to the extent of some percentage, e.g., 85 percent, of the taxable income (again computed without reference to net interest expenses) above that floor. Disallowed interest would be carried over.

This approach would avoid a number of the problems involved in attempting to create a legal definition of a reasonable amount of debt, but it would also present some additional problems of its own. Perhaps most troublesome is that it could deny interest deductions, at least temporarily, to corporations that had reasonable capital structures but were incurring economic losses. This problem might be dealt with by limiting the amount of disallowed interest to the amount of the taxpayer's preferences--thus, no deduction would be denied to the extent the interest gave rise to an economic loss. Structured in this fashion, it would operate

essentially as a check on the tax arbitrage involved in debt financed acquisitions of assets generating tax preferred incomes. Whether limited to preferences or not, this disallowance of excessive interest deductions would create somewhat of an incentive for high debt corporations to avoid the limitation by combining with low debt corporations (an effect similar to that which would be caused by an alternative minimum tax). Another, probably more serious problem that would be created by this limitation (or any other effective limitation on indebtedness) is that it would put great pressures on potentially affected corporations to avoid it by securing financing through debt substitutes not subject to the limits. For example, short sales, forward contracts, and other financial arrangements can be structured to resemble loans closely. While anti-avoidance rules could be adopted, it is likely that there would be some slippage at the margins. Notwithstanding these problems, it would be a fairly simple mechanism to prevent corporations from using a combination of leverage and tax preferences to shelter themselves completely from corporate tax.

Limitation on acquisition indebtedness.--There are a number of more narrowly focused proposals that would deny deductions in certain circumstances for interest on debt incurred to finance corporate acquisitions. (Present law, without much effect on merger activity, denies the interest deduction on a very limited category of subordinated and convertible acquisition indebtedness. Sec. 279.) Under some proposals, deductions would be denied for interest on acquisition indebtedness where the rate of interest is excessive--so-called "junk bonds." Other proposals would limit the interest deductions only where debt is incurred in a hostile acquisition.

While there may be nontax policy considerations supporting limitations on the deductibility of interest on acquisition indebtedness, it is not clear that there are tax policy reasons for differentiating between acquisition indebtedness and other debt. Acquisition indebtedness raises tax policy considerations in highly leveraged transactions where it approaches equity in substance. However, excessive leverage presents essentially the same tax policy concerns whether or not it arises in the context of mergers and acquisitions, and thus generally applicable debt/equity limitations might be more appropriate. If reasonable, workable limitations can be devised for high risk, low quality junk bonds issued to finance corporate acquisitions, it might be appropriate to extend those limitations across the board to all debt of that nature, whether issued in a corporate acquisition or not. (This, of course, is essentially the option described in the previous section.)

Another concern is whether an effective limitation on acquisition indebtedness can be designed. Since debt is to a

large extent fungible, it is intrinsically very difficult if not pointless to trace debt to an acquisition. It may be relatively easy to do so initially in the straightforward case where substantial amounts of debt are incurred explicitly to acquire the stock of the target corporation, but it would become increasingly difficult to associate the debt with the acquisition as time passed and intervening transactions blurred the connection. New debt might be incurred and used, directly or indirectly, to retire the acquisition debt, the corporate shell of the target might be liquidated, assets of the target might be sold, etc. There would be a great incentive to avoid the limitations, and it probably would be impossible to draft completely effective limitations.

In addition, there is a real question as to how effective limitations on the deductibility of interest on acquisition indebtedness would be in the not infrequent situation where the acquirer intends to dispose of some or all of the assets of the target in order to retire the debt--acquisitions premised on the belief that the break-up value of the target's assets exceeds the market value of its stock. Debt incurred in highly leveraged transactions may very well significantly exceed the amount necessary to offset the corporate tax fully. The acquisition would proceed with as much debt as would qualify under whatever limitations were imposed, and the excess would be financed with preferred stock or other securities that would be retired shortly after control is obtained with the proceeds from the disposition of assets of the target. Under circumstances such as these, limitations on acquisition indebtedness would not have a significant impact. Moreover, one tax advantage that does exist in these circumstances is the ability to dispose of the assets in liquidation (secs. 336, 337 and 338) without recognizing full gain--the General Utilities issue discussed in greater detail in Part III(2).

Despite these technical difficulties, a limitation on the deductibility of interest on acquisition indebtedness would at a minimum make it far more cumbersome than it is today to mount a debt financed acquisition--particularly one without the active support of the management of the target corporation. Thus, while far from perfect, limitations on excessive acquisition indebtedness might partially accomplish their intended objectives without raising the various collateral issues inherent in the more comprehensive proposals previously discussed.

III. TAXATION OF MERGERS AND ACQUISITIONS

In this part, I will attempt to compare the tax consequences of the various types of transactions in which corporate assets may be transferred, ranging from the sale of the assets in the ordinary course of business to the several forms of merger and acquisition transactions available.

Perhaps the most important policy question to consider in analyzing the current tax treatment of mergers and acquisitions is whether, and to what extent, the possible tax consequences have a destabilizing effect (relative to other biases built into the system, as discussed above), tending to encourage mergers and acquisitions that would not otherwise take place.

As discussed in the introduction, the question of whether the tax laws create a bias toward mergers and acquisitions is considerably more subjective than it might at first appear. For any particular set of facts and circumstances, it is a relatively straightforward exercise to determine the tax consequences of the various possible forms in which a merger or acquisition could be structured. The difficulty in determining whether the tax laws are neutral with respect to mergers and acquisitions is determining what they should be neutral with respect to.

From one perspective, a corporation is not just the sum of its assets but is an continuing entity separate and distinct from its shareholders. Under this view, the acquisition of the stock of one corporation by another does not affect the independent existence of the target. Thus, it would be argued that neutrality should be tested by comparing the tax consequences to the parties of a merger or acquisition with the tax consequences to the parties if no transaction were to occur. This analysis would attempt to identify those situations where a churning incentive exists because the present value of the taxes facing the parties in the aggregate is reduced as a result of the transaction.

From another perspective, however, the acquisition of the stock of one corporation by another may be viewed as being tantamount to the acquisition of its assets. Effective ownership of the target's assets has been transferred; failure to recognize that for tax purposes is itself distorting. Thus, it would be argued that neutrality would be achieved by consistent treatment of the acquisition of a corporation's stock and the acquisition of its assets.

Which of these two views is more reasonable depends in part upon the facts of the particular case. The following discussion attempts to analyze the tax rules governing mergers and acquisitions from both perspectives.

In addition to neutrality, two other policy considerations deserve mention in this context. There is generally some reluctance about allowing taxpayers elections relating to the tax treatment of a transaction unless a strong case can be made that the election is appropriate. Understandably enough, taxpayers, given the opportunity, will tend to elect against the fisc. The greater their ability to self select the tax treatment of their transactions, the more they are likely to minimize their taxes. The current rules governing mergers and acquisitions allow taxpayers considerable leeway to pick and choose among several different tax regimes, either as the result of express elections or de facto ones resulting from the taxpayer's ability to choose and relative indifference to the form selected for effecting the transaction.

Second, in an income tax system where income is not taxed until it is realized, it is important to limit to the extent possible the situations where taxpayers can effectively transfer their ownership of assets without recognizing gain. As noted in the introduction, an obvious bias against recognizing gains and in favor of realizing losses is inherent in our system, and taxpayers inevitably have great latitude over what income and expense they recognize and when the recognize it. They will tend to recognize income when the nontax considerations for doing so outweigh whatever tax hurdle exists. To the extent the system provides sufficient flexibility for taxpayers to accomplish their nontax investment objectives (e.g., exchanging one investment for another) without being required to suffer a tax, they will tend to do so. An effective income tax requires that flexibility not be unrestricted. (Conversely, similar considerations lead to a policy against allowing taxpayers to recognize losses when they have not meaningfully changed their position.) Nevertheless, nonrecognition treatment is frequently provided for exchanges of property because these considerations are outweighed by considerations of liquidity and valuation or because the taxpayer is viewed as continuing the same investment in modified form. It is seldom obvious how these considerations should be balanced, and the necessary line drawing between nonrecognition and recognition treatment is one of the more difficult policy issues in the mergers and acquisition area.

As discussed in greater detail below, depending upon how the transaction is structured, the possible tax results applicable to transfers of assets held in corporate solution fall into four general patterns:

(1) Treatment by all parties as sale of assets, with full gain or loss recognized to the selling corporation and a basis step-up to the acquiring corporation;

(2) Treatment as a taxable sale of stock by the target corporation's shareholders but as a purchase of assets by the acquiring corporation--with the taxation of the target corporation limited to the recapture of certain previously claimed tax benefits but a full step-up in the basis of its assets in the hands of the acquiring corporation and a termination of the target's tax attributes;

(3) Treatment by all parties as a sale of stock in the target corporation, with gain or loss recognition to the selling shareholders, no gain recognition by the target corporation, and, in general, a carryover of the target's tax attributes; and

(4) Treatment as a tax-free reorganization, with a substitute basis and no gain or loss recognition to the target company shareholders on the stock they receive in the exchange and no recognition of gain or loss by the target corporation and a carryover of its tax attributes.

The more detailed discussion of these four possible tax consequences follows.

(1) Taxable asset sale.

The selling corporation remains independent and sells its assets to the purchaser in the ordinary course of business. It pays tax at rates up to 46 percent on its sale of ordinary income assets and on certain recapture items and 28 percent on its capital gain income. Similarly, losses on the sale of assets are also recognized, typically as ordinary losses. The selling corporation then distributes its after-tax profits to its shareholders as dividends, taxable to them as ordinary income, and the shareholders may then reinvest their after-tax return as they choose. As discussed in Part II, this may result in an aggregate corporate/shareholder tax of up to 73 percent.

(2) Transaction treated as a sale of stock by target company shareholders but as a purchase of assets by purchasing corporation.

This result may be obtained by structuring the transaction in one of three different ways.

(a) Section 331 liquidation followed by sale of assets.--The target corporation distributes its assets to its shareholders in liquidation who then sell those assets to the purchasing corporation.

In this transaction, the target corporation recognizes gain on its distribution of appreciated property only to the extent of any so-called recapture items, such as depreciation previously claimed on personal property to the extent of gain, a portion of depreciation on certain real property, certain intangible drilling costs and mining exploration expenses previously claimed on certain oil and gas and mineral reserves, LIFO reserves, ITC not yet fully accrued--generally deductions and credits that would be recaptured if the target had sold the assets in the ordinary course of business. However, all other gain that would be taxable on a sale of the assets in the ordinary course of business would not be taxed to the target corporation on the distribution in liquidation (sec. 336). The target corporation's shareholders would be treated as having sold their stock for the fair market value of the assets they receive in liquidation. Thus, they would pay capital gains tax on the receipt of the assets in exchange for their stock, just as they would if they had sold their stock to a third party. The shareholders would receive a basis in the assets equal to their fair market value, so no gain would be recognized on the subsequent sale of the assets to the purchasing corporation. The purchasing corporation receives a basis in the assets equal to its purchase price.

(b) Sale of assets under section 337 followed by liquidation.--Rather than distributing all its assets to its shareholders in liquidation followed by a sale of the assets by the shareholders to the purchasing corporation, the target corporation might instead sell its assets to the purchasing corporation directly and distribute the proceeds (both profit and capital investment) to its shareholders in liquidation. Since, as a practical matter, in many cases there would be no significant differences between this and the previous transaction, the tax law generally treats the two transactions alike, provided the proceeds from the sale by the target of its assets (other than those retained to satisfy claims of creditors) are distributed within one year of its adopting a plan of liquidation (sec. 337). Thus, the target corporation pays tax only on the recapture items, its shareholders pay capital gain tax on their stock on the difference between their basis and the amount of the distribution they receive, and the purchaser receives a stepped-up basis in the assets.

(c) Sale of stock and section 338 deemed liquidation.--As a third variant of this transaction, much the same result may be achieved where the target corporation's shareholders simply sell all their stock to the purchasing corporation. For many transactions, the parties are, from a nontax standpoint, in substantially the same position that they would have been under the two previous transactions. The target corporation's shareholders have

cash in place of their stock. The purchasing corporation effectively owns the assets of the target corporation--it owns them through its ownership of all the stock of the target corporation, but from many standpoints that is more a matter of form than substance. Since the parties in many cases, by following the form of the liquidating sale transactions described above in (a) or (b), could have effectively placed themselves in this position, the tax law (sec. 338) allows the purchasing corporation, if certain requirements are met, to elect to treat the transaction as if it were conducted as a liquidating sale. (Note that in many cases a liquidating sale is not a viable alternative from a business standpoint, and thus this is the only alternative available to reach this tax result.) The selling shareholders are taxable on their gain on the sale of stock. If the purchasing corporation makes an election under section 338, the target corporation is deemed instead to have sold all its assets and liquidated in a transaction that qualifies under section 337, as described in (b) above. Accordingly, the shareholders are taxed as having sold their shares and the target is taxable only on its recapture items. At the same time, the target corporation now in the hands of the purchasing corporation is treated like a new corporation without any of its former tax attributes that has purchased all of its assets for the amount paid to the target shareholders; accordingly, the basis in its assets is stepped-up.

A clear distortion that provides an incentive for an acquisition exists in some cases because of this tax treatment. The incentive arises because of the failure to tax the target corporation on the full amount of its gain on the transfer of its assets--the so-called General Utilities doctrine. There is a tax-free step-up in basis equal to the amount of the gain not recognized to the target corporation on its disposition of its assets. The purchasing corporation will benefit from this stepped-up basis since it will have larger depreciation deductions, less gain on the sale of inventory, etc. Thus, the gain that is not recognized will permanently escape corporate tax. The assets have a higher value to the purchasing corporation than they did to the selling corporation to the extent that the present value of the tax benefit of the step-up to the buyer exceeds the present value of the tax on recapture items paid by the target corporation. Any such excess creates, at the corporate level, an incentive to effect the transaction. While it appears that in most cases the burden of the recapture taxes outweighs the benefit of the step-up, in a significant minority of cases this treatment proves advantageous. A countervailing factor exists, at the shareholder level, to the extent that the present value of the capital gain tax paid by the shareholders on the disposition of their stock exceeds the present value of the tax the shareholders would have paid if the target

corporation were not sold.[8]

Whether this treatment adds up to a meaningful tax incentive to sell the target corporation depends upon the facts of the particular situation. There are a number of cases involving significant tax benefits where it does appear to. In most cases, however, it does not. Since the changes made by the 1982 Act requiring consistent treatment by the purchaser for all the target's assets in section 338 transactions, it appears that most of the acquisitions of relatively large publicly traded corporations have not involved section 338 elections because the tax on the recapture items would have exceeded the present value of the tax savings attributable to the step-up.[9] (Prior to the 1982 Act, step-up treatment often could be obtained for those assets of the target that did not have significant recaptures associated with them and carryover treatment for those that did--under those rules, step-up treatment was fairly common.) It should be noted that, if in the course of comprehensive tax reform, Congress repeals the investment credit and modifies depreciation so that the allowances more closely track the actual decline in value of assets, the potential recapture tax in any transaction will be reduced substantially and the relative attractiveness of step-up treatment will increase.

To the extent a taxable sale of the target's assets is viewed as the more appropriate comparison, the stock sale/asset purchase treatment provided these three types of transactions is almost invariably more favorable. (A taxable

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[8] Among other things, the analysis of the no-sale alternative turns on whether and when the target corporation would distribute its earnings as dividends and whether and when the shareholders would otherwise have disposed of their stock. This countervailing factor is reduced where the stock is sold on an installment basis and the tax on the gain is deferred; it is eliminated where the shareholder is nontaxable (e.g., most institutional and foreign investors). Note that the incentive to undertake the transaction is increased where target's basis in its assets is lower than the basis that its shareholders have in its stock. A higher outside basis may result from previous sales of stock where gain was recognized, from tax-free step-ups at death (sec. 1014), or otherwise--but in analyzing the question of whether there is a present incentive to undertake the transaction the question is not whether tax has been paid in the past, but what is the tax hurdle now. Note further that taxable low-basis shareholders may have little choice about selling their stock, especially in two-tier acquisitions, where the purchaser(s) acquires majority control with shares tendered by high-basis or nontaxable shareholders.

sale might be preferable if the target had an unrealized loss in its assets.) Thus, the availability of this preferred treatment in some cases may create an inducement for the sale of the corporation (or the sale of its assets in liquidation) rather than the sale of the assets where the target corporation retains its independent existence. This comparison might be particularly relevant in the not infrequent case where an investor or group of investors attempts to acquire control of a corporation so that its assets can be sold off--believing its parts are more valuable in the market than the whole. Under these rules, the acquirers can dispose of the assets of the target, incurring tax only on the recapture items. In contrast, the target, if it attempts to continue to exist as an independent entity, will be fully subject to tax on the gain realized on the sale of its assets. This is true even if the existing management concurs with the "corporate raiders" that a contraction of the corporation or a redeployment of its capital out of certain of its existing businesses would be advisable from a business standpoint. Should it decide to remain in existence, any gain on the sale of its assets in pursuit of such a policy would be fully subject to tax. (Under certain circumstances, the target corporation can, however, make a nontaxable distribution of existing businesses to its shareholders in a spin off or split up qualifying under sec. 355. On occasion, these transactions are also used in the context of a corporate acquisition. Where this approach is followed, however, the business remains in corporate solution and no tax-free basis step-up is provided.)

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It is frequently the case, particularly in the corporate tax area, that taxpayers and their tax advisors can devise more or less elaborate schemes for carrying out their affairs that achieve business results substantially similar to those desired without the adverse tax consequences that more straightforward approaches would entail. The question facing them is whether the game is worth the candle. Broadly speaking, revenue is collected because there is sufficient transactional friction in the system that it is more advantageous for taxpayers to pay tax than to undertake the steps necessary to avoid it. Commentators have suggested various tax planning strategies for avoiding the consistency requirement imposed by the 1982 Act that would, if employed, permit step-ups where the recaptures are not large and carryovers where they are. However, the evidence to date is that these strategies have not been widely used in transactions involving publicly traded companies, presumably because they are unsatisfactory from a business standpoint. Perhaps, however, as these strategies become refined and more widely known, their use will increase.

While the distorting effects of the General Utilities doctrine have long been recognized, there has been considerable controversy whether the cure, repealing General Utilities and requiring full gain recognition, is worse than the problem. The objections stem from opposition to extending the double tax on corporate income--even though the opponents generally concede that failure to tax this gain at both the corporate and shareholder levels is inconsistent with the general corporate tax scheme and seriously distorts taxpayer behavior.

Opposition to taxing the liquidating corporation on its full gain has typically been concerned with the heavy burden that such tax treatment would place on investors in small businesses and real estate who wish to invest through corporations. The focus of the concern has not been acquisitions of large publicly traded corporations. For the latter corporations, however, General Utilities almost invariably arises in the acquisition context--whether pursuant to a section 338 election after control has been acquired, pursuant to section 337 on the disposition of the target's assets after control of the target corporation's stock has been acquired, or pursuant to section 337 by the existing management after the corporation has been put in play by a hostile tender offer. It is a rare event when such corporations decide to terminate their affairs outside the acquisition context. Consequently, opposition to the repeal of General Utilities would probably be defused significantly if relief from the double tax were provided for long-term direct investors or for closely held smaller corporations.

(3) Sale of stock without liquidation.

A third option for the tax treatment of the transfer of the assets of a corporation is achieved when the transaction is structured as a sale of the stock in the target corporation to the purchasing corporation without a liquidation (or deemed liquidation) under sections 331, 337 or 338. In this case, the selling shareholders are taxed on the gain on their sale of stock. The target corporation is not taxable even on recapture items since it is viewed as continuing to remain in existence without having transferred any of its assets, and the basis of its assets does not change. So, while the shareholders recognize gain on the sale of their stock in the target, no transaction is treated as having occurred at the corporate level even though the target corporation's shareholders no longer have any continuing interest in the assets, and the purchasing corporation, through its newly acquired subsidiary, now effectively owns all the assets previously held indirectly by the target corporation's shareholders. Indeed, the purchasing corporation presumably will include the income or loss generated by those assets in its consolidated return

just as if it held the assets directly. Nevertheless, the basis of the new subsidiary's assets used in computing its income, and accordingly by that of the acquiring consolidated group, will be the basis determined by reference to the historic cost of these assets to the target corporation rather than by reference to the purchase price that the acquiring corporation paid to acquire effective ownership of the assets. (Moreover, after some time, it if so desires, the purchasing corporation may liquidate the target corporation and hold those assets directly with no tax consequences flowing from the liquidation.) Thus, the purchasing corporation may be viewed as acquiring the assets of the target corporation with no tax to the target corporation but a carryover basis to the purchasing corporation and a capital gains tax paid by the target corporation's shareholders on their sale of the stock.

If one assumes that the purchasing corporation will cause the target corporation to sell its assets at the same time subject to the same tax as if ownership of the target corporation had not changed and one also assumes that the purchasing corporation will distribute its profits at the same time subject to the same tax to its shareholders as the target corporation would have, then, but for the possible increase in the debt/equity ratio and the possible conversion of dividend income into capital gains discussed in Part II above, in most such cases the tax system would appear to achieve neutrality with this treatment. (This tax treatment may in fact discourage such acquisitions because of the acceleration of the gains recognized by the target corporation's shareholders on their stock sale.) Nevertheless, in some cases, a tax incentive may still exist where a potential acquirer can put the carried over tax attributes of the target to greater use than the target could standing alone. Moreover, to the extent the acquisition of all the stock of a corporation is viewed as the functional equivalent of the acquisition of all its assets, a stock acquisition with nonrecognition of gain and carryover of tax attributes at the corporate level is clearly more attractive from a tax standpoint in most situations than a fully taxable asset acquisition.

One type of transaction where the carryover of the target's tax attributes might be viewed as troublesome is where a currently taxable corporation purchases the stock of a corporation not currently taxable because it has net operating losses (NOLs) or excess tax credits. Subject to limits imposed by the Code (secs. 269, 382, 383 and 482) and by the consolidated return regulations, the taxable acquiring corporation may be able to avail itself of some or all of the

NOLs and credits that carryover in the transaction. The same is true of as any "built-in" loss resulting from a basis in the target's assets that is higher than the amount paid to acquire the target's stock.[10] Where, as frequently is the case, the target corporation is not well positioned to utilize its tax benefits, the target is less valuable standing alone than it is to a potential acquiring company that can successfully avoid the present law limitations on the use of NOL and credit carryovers. As presently structured, those limitations are relatively easy to avoid, and thus present law in this area tends to induce acquisitions of corporations with excess tax benefits.

Comparable tax advantages arise in situations where a loss company acquires a target corporation with a built-in gain, i.e., when the basis of the assets held by the target is less than the amount paid to acquire its stock. The accrued but untaxed gain of the target is transferred in effect to the consolidated return of the acquiring loss corporation and sheltered from tax by its losses or credits that otherwise could not have been used currently if at all.[11] With very limited exceptions (sec. 382(b)), no limitations are imposed under present law on the acquisition of built-in gains by loss companies.

Various possible policy objectives might be pursued with respect to acquisitions involving NOL and credit carryover companies. Limitations might, for example, be designed to prevent the effective transfer of currently unusable tax attributes (or sheltering of built-in gains) through

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[10] Under the separate return limitation year (SRLY) rules of consolidated return regulations, built-in losses of a new member of the affiliated group cannot be used in consolidation to offset post-acquisition tax liabilities of the other members of the group. The regulations define built-in losses to be the amount of any losses attributable to the excess of the adjusted bases of the assets of the new member over their fair market values. There are problems with this definition of built-in losses. Valuation of the new affiliate's assets is inherently problematic. Moreover, it seems reasonably clear that, at least where most of the stock of the new affiliate was acquired within the year or two prior to affiliation, the built-in loss should be no less than the excess of the adjusted bases of the new affiliate's assets over the price paid to acquire its stock. Any excess of the bases of the assets of the new affiliate over the amount paid for its stock presumably reflects a potential loss or expense which will be deducted against the income of the acquiring group if and when sustained through depreciation or otherwise.

corporation acquisitions, to prevent potential acquirers from obtaining greater value from the attributes than the target could have, or merely to limit their value so that it does not exceed the value of the other assets of the target. These issues are scheduled to be examined in depth in separate hearings by the Select Revenues Subcommittee, so I won't attempt to cover them here other than to observe that any comprehensive rules in this area necessarily would be complex and controversial.

If the policy objective were to eliminate the tax advantages that corporate stock acquisitions enjoy compared with taxable asset sales, far and away the most effective option would be to treat the acquisition of control of a corporation like the acquisition of its assets. Presumably, this would be accomplished by treating the acquisition of control over some time period as automatically constituting a section 338 election triggering the target's recaptures and allowing a step-up in the basis of the target's assets. If General Utilities were repealed, the full gain or loss on the target's assets could be recognized on a change in control with appropriate basis adjustments. With or without a repeal of General Utilities, this would also be far and away the most controversial option. Controversy is the inevitable handmaiden of effectiveness in this area, but this option would be particularly controversial (especially among tax experts in the mergers and acquisitions area) because it conflicts with the traditional frame of reference of viewing these transactions--that is, that transactions at the shareholder level should generally be permitted to proceed without affecting the tax results at the corporate level. Although there are situations under current law where changes of control can affect the results at the target corporation level (in limited circumstances with respect to NOLs and

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[11] The transfer of a corporation with built-in gains frequently involves the conversion by the transferor of ordinary income into long-term capital gains rather than the avoidance by the transferor of any income whatsoever. For example, suppose a corporation purchases an airplane for $100 million and transfers it to a shell subsidiary. Depreciation deductions of $100 million would be claimed in the first 5 years the plane is in service. If, after that period, the subsidiary were to sell the plane for, say, $75 million, that full amount would be recaptured as ordinary income currently. If, however, the stock of the shell subsidiary were sold, the gain would be long-term capital gain. A similar conversion of short-term capital gain into long-term capital gain was involved in Mesa Petroleum's disposition of its Gulf stock, discussed above in footnote 4. A similar deferral through the installment sale of the stock (but not the plane) would likewise be available.

credit carryovers and, more importantly, in situations where the taxpayer elects to treat a stock acquisition as an asset acquisition (sec. 338) because that treatment is favorable), the mandatory asset sale treatment for corporate acquisitions would be extremely disruptive of existing patterns of behavior.

The argument in favor of this option is that it attempts to conform the tax consequences of a corporate acquisition with the economic realities--the beneficial ownership of the target's assets has effectively been transferred and the transaction should be taxed as such. Regardless of how other transactions are taxed, taxpayers will always have the option of an asset sale with recognition and step-up treatment. To the extent rules could be designed to work effectively to treat corporate acquisitions in that same fashion (a matter that is open to serious question), the flexibility of present law permitting taxpayers to choose either nonrecognition and carryover treatment or recognition and step-up treatment would be cut back significantly. Gain accruing before the acquisition would be taxed and thus could not be avoided after the acquisition through deductions for interest on junk bonds, unusable tax benefits of the acquiring corporation, or otherwise. Similarly, built-in losses, NOLs and credit carryovers of the target would be eliminated.

Given the potential magnitude of the tax impact for acquisitions of corporations with substantial unrealized income, there would be great pressure at the margins to structure transactions so that they would fall outside of any such rule. Although such efforts might be successful in certain situations, there is little doubt that generally treating the acquisition of a controlling interest in the stock of a corporation like a taxable acquisition of its assets would significantly diminish the attractiveness of a great many corporate acquisitions. To a far greater extent than any of the other options discussed in this testimony, this option would significantly cut back on the number of corporate acquisitions that take place. Whether this treatment is appropriate turns largely upon whether one views an acquisition of control of a corporation as the functional equivalent of a taxable acquisition of its assets.[12]

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12 Another way in which the tax consequences of acquiring a corporation and acquiring its assets could be conformed would be to allow the parties, regardless of which form the transaction takes, an election to treat it either as a nonrecognition carryover transaction or as a recognition and step-up transaction. This essentially is the proposal of the American Law Institute and has been endorsed in the Senate Finance Committee staff study on subchapter C. I have not

(Footnote continued)

(4) Tax-free reorganization.

A final tax option available to the parties is for either the stock or the assets of the target corporation to be transferred to the purchasing corporation in a statutory merger or other transaction qualifying as a tax-free reorganization.[13] The target corporation's shareholders would receive, at least in part, stock in the purchasing corporation (or, in certain structures, stock in an affiliate) and possibly other consideration. To the extent the target corporation's shareholders receive stock, they generally will not be taxable on the exchange and their basis in the new stock will equal their basis in the target corporation stock they exchanged therefor, thereby leaving them in the same tax position (although perhaps, a significantly different economic position), as if the transaction had not occurred. To the extent they received consideration other than stock, depending upon the circumstances, they may be taxed as having recognized capital gains on the disposition of a portion of their stock or as having received a dividend taxable at ordinary income rates. At the corporate level, no gain or loss is recognized even in the case of recapture items. Thus, to the extent the target corporation's shareholders receive stock or other consideration qualifying for nonrecognition, no transaction is viewed as having occurred for tax purposes either at the corporate or the shareholder level.

This transaction differs from those previously discussed because, while the purchasing corporation now owns the target

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[12](continued)
discussed this approach here because I understand the subcommittee's focus to be on proposals designed to reduce tax incentives for mergers and acquisitions, and the proposal for elective step-up or carryover treatment is intended less as a change in the present tax consequences of corporate acquisitions than as making the current de facto election explicit and less cumbersome.

[13] There are several different types of transactions that qualify for tax-free reorganization treatment under present law, each involving somewhat different requirements. Some observers have urged that Congress reexamine this area and adopt a uniform set of requirements to apply regardless of the form of the transaction. There would appear to be considerable room for improvement in this regard, even if the requirements were not, on balance, liberalized or tightened. I have not pursued that topic here because I understand these hearings to be focused more on those tax rules that might operate to influence the incidence of mergers and acquisitions.

corporation's assets, the target corporation's shareholders continue to have an indirect (but diluted) interest in those assets through their newly acquired stock ownership in the purchasing corporation; they have not been cashed out as in the previously discussed options. On a subsequent sale of the purchasing corporation's stock that the target corporation's shareholders had received in the reorganization, the target corporation's shareholders would then be in substantially the same position as in the prior examples.

The extent to which one considers the treatment of a tax-free reorganization as being more favorable than the treatment afforded the sale of assets by the target corporation in the ordinary course of its business depends upon whether in the case of a tax-free reorganization one views the target corporation's shareholders and the target corporation to have changed their positions substantially enough to justify imposing a tax on the transaction or whether one views the transaction essentially to be a modification of a continuing investment. This judgment would seem to depend in part on the relative size of the two parties and the vantage point from which the transaction is viewed. If, for example, the purchasing corporation[14] were 99 times larger than the target corporation and the target corporation's shareholders received only a 1-percent interest in the purchasing corporation, the target corporation's shareholders might reasonably be viewed as having disposed of their interest in the target corporation's assets and made a new investment in the purchasing corporation--a change which might be viewed to be sufficiently analogous to the sale transactions discussed above to justify treating the transaction as a recognition event to the target corporation and its shareholders (or, at a minimum, limiting the use of its tax attributes by the surviving corporation). If, however, the transaction were viewed from the vantage point of the purchasing corporation and its shareholders (whose interest has only declined from 100 percent to 99 percent), there hardly seems to have been a sufficient change in position to justify treating the transaction as a taxable event. Similarly, if the two parties were of roughly equal sizes, it becomes much more difficult to maintain that the transaction should be taxable from the vantage point of either side.

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[14] For ease of reference, I am using the term "purchasing corporation" loosely to refer to the corporation whose shareholders end up controlling the majority interest in the surviving corporation. The choice of the surviving party in a reorganization, be it the target corporation or the purchasing corporation, is frequently only a matter of form.

Under current law, the relative size of the parties does not affect the tax treatment of the transaction (other than with respect to certain limitations on carryovers of net operating losses and other tax attributes under sections 382 and 383). One option that could be considered is the limitation of tax-free reorganization treatment to transactions where the relative sizes of the parties are sufficiently similar that the substance of the transaction is more in the nature of a joint venture and less in the nature of a complete change in investments. For example, the House-passed version of the 1954 Code limited reorganization treatment to transactions where the difference in relative size of the parties did not exceed a four to one ratio. (This limitation would not have applied to statutory mergers involving corporations with more than ten independent shareholders.) As in 1954, of course, any such proposal would be controversial.

IV. CONCLUSION

In this testimony I have attempted to describe the various aspects of present law that might be viewed as contributing to merger and acquisition activity. While it is my firm belief that certain tax incentives do exist, it is also readily apparent that they cannot by themselves account for the remarkable increase in mergers and acquisitions in the last several years; to the extent such tax incentives exist, they have existed, by and large, for years. One exception, the increase in corporate cash flow relative to earnings caused by the capital cost recovery changes in the 1981 Act, would not appear to be sufficient to account for this activity. (One other relatively recent tax change, the 1975 Act repeal of percentage depletion for integrated oil companies, may be viewed as an indirect contributing factor in that it subjected these firms--major players in this recent round of corporate acquisitions--to the same tax influences that affect other firms.)

Rather, this increase in merger and acquisition activity seems to be better explained by changes in other areas. There has been a significant relaxation of the antitrust restrictions imposed on corporate combinations. The deregulation of a number of industries has operated both to permit corporate restructuring and consolidation change and even to force such changes. The financial services industries operate in a significantly less restrained atmosphere. They have developed new financing techniques such as junk bonds that have been important tools in financing acquisitions, of particular importance in a number of recent acquisitions where it is highly unlikely that the purchasers would have been able to raise sufficient funds through traditional techniques to make the acquisition attempts. In addition, deregulation of the financial services industries has increased the pressure on financial institutions to increase their yields, pressuring them to participate in these transactions. The relative glut in the market in recent years has forced a contraction in the oil and gas industry, accomplished in part by a number of major corporate acquisitions. There are, no doubt, a number of other nontax factors that also help account for the increase in merger and acquisition activity.

To say that nontax factors appear to be the primary causes of the increase in merger and acquisition activity is not, however, to say that the tax incentives do not have a powerful effect. A more realistic view of the situation may be that this change in the business environment has intensified the effect of the preexisting tax incentives or has eliminated many of the nontax barriers that had previously offset the tax incentives. I have outlined in the testimony various possible changes in the tax law that, although controversial, might be considered if you wished to eliminate the tax incentives for mergers and acquisitions.

Chairman PICKLE. Thank you, Mr. Brockway.

I am like the other members of the committee; I have a little bit of difficulty following your charts and your summation of how we treat these corporations. I want to come back to some of those questions.

I think I would like to use my time by asking some fundamental questions that have been raised here this morning.

If there are tax incentives that bring about and cause these mergers, would you list for me several of these tax incentives and comment on which are probably the most likely ones these corporations are using today?

Mr. BROCKWAY. Well, Mr. Chairman, the problem is that there aren't specific provisions of the code that directly cause mergers and acquisitions.

Most of the tax incentives for mergers and acquisitions, to the extent you view them to be problem areas, stem from the general fundamental rules of taxation of corporations. Having a double tax on dividend distributions but not on debt is, in large part, the principal tax factor motivating takeovers, friendly or hostile, and leveraged buyouts.

All those transactions appear in part to be driven by the advantage of switching from equity capitalization to debt capitalization.

Some transactions appear to be driven by the fact that a corporation, if it acquires the stock of another corporation and makes an election to treat it as a purchase of assets under section 338, can receive a tax-free step up of basis in the acquired assets. And in that situation, that tax advantage may very well be one of the motivating factors in the transaction.

There are other transactions—for example, the payment of greenmail—where the tax rules, other than the general impact of the difference in treatment of debt and equity, would not appear to motivate the transaction. However, we understand that there may be situations in which taxpayers are taking the position that they are allowed to deduct the greenmail payment. Now, I doubt that that is an appropriate tax treatment of the transaction, but certainly, if that is being done, it helps facilitate the transaction.

Again, the failure of the rules dealing with the transfer of the net operating losses and credit carryovers to deal completely with that problem will facilitate transactions where there are substantial loss and credit carryovers that aren't currently being used. That is a growing phenomenon in the corporate sector now.

Chairman PICKLE. My question was on the assumption that there were tax incentives that were encouraging these mergers.

Let me be more specific. You've got the deductibility of interest, one major one, the stepped-up basis, the net operating losses in many instances, installment sales, ESOP's, greenmail and other factors. Do you have any feeling about which is more important or are they all important or are there other factors?

Mr. BROCKWAY. Well, I think they are all important. Which of these rules is the most significant factor really depends upon the particular transaction. You may well find that some of the more important items——

Chairman PICKLE. Are any of those more important than others that you know of?

Mr. BROCKWAY. I would say that the difference in taxation of debt and equity is the most important.

Chairman PICKLE. Debt equity versus the deductibility of interest?

Mr. BROCKWAY. That is correct. I would say that is the most important factor.

Chairman PICKLE. You said earlier that one of the main concerns you have about this is the double taxation system in the regular corporate structure.

Do you want to comment further at this particular point on why that is important?

Mr. BROCKWAY. Well, I think it is important because a double tax on equity but only a single tax on debt puts a great bias in the system for corporations to switch their equity financing to debt financing, whether by themselves or through the form of an acquisition, friendly or hostile.

And that is one of the factors, I think, that is causing the difference in values between outstanding stock and the underlying assets of corporations, which is a major driving factor in these transactions.

Chairman PICKLE. You said that a lot of the takeovers are brought about because of nontax reasons, and I assume that you meant to say that a majority of them are because of nontax reasons.

I don't know that we can put any percentage on it, but recognizing that there will be some nontax incentives, the marketplace, diversity, distribution characteristics, all of those things are important. I want to recognize that there are a lot of reasons why these mergers might be coming about that are not related to tax incentives.

But with respect to the one incentive that you did mention, the deductibility of interest, would you agree that the deductibility of interest is a tax incentive?

Mr. BROCKWAY. I don't know that I would say that the deductibility of interest itself is a tax incentive. I would say that having deductibility of interest but not deductibility of dividends is a distortion of the marketplace that creates an incentive to go through these transactions.

Chairman PICKLE. Why should we be concerned about the deductibility of interest?

Mr. BROCKWAY. To the extent that you feel that the tax system causes corporations to be much more heavily debt financed than they would be in the absence of these distortions, there is reason to be concerned that there might be serious undesirable economic effects.

In addition, I think you should be concerned about it because, if there is this value that is created through an acquisition by switching over to debt financing, that value that will be realized, that tax value will affect the potential price of the deal and will induce more acquisitions to occur than otherwise would take place.

Chairman PICKLE. Should a target company be allowed to take deductibility of interest?

Mr. BROCKWAY. I believe that as a general matter interest should be deductible. I don't think that the answer here, as a general matter, would be to eliminate the deductibility of interest.

You may, as a general matter, put some restrictions on the extent to which a corporation, at least a publicly traded corporation, might be debt capitalized, and you may possibly try to think of ways to impose limitations on the deductibility of interest when it arises out of an acquisition.

There are certain limitations in present law, but it is very difficult to develop effective limitations.

Chairman PICKLE. If we allow the target corporation to have a deductibility of interest and if the acquisition proceeds and then the acquiring company does take over, we also allow deductibility of interest by the acquiring company.

Now, is that a double whammy?

Mr. BROCKWAY. No; I don't think so because in that situation, the acquiring——

Chairman PICKLE. So you would allow under the law——

Mr. BROCKWAY. Only one of the two corporations will be paying the interest and therefore only one will be deducting the interest.

It really doesn't make much difference in the transactions whether it is the acquired corporation doing the borrowing or the acquiring corporation. Either way there is only one deduction for the interest.

Chairman PICKLE. If you allow the interest deduction, is not the Government losing revenue?

Mr. BROCKWAY. The Government will lose revenue any time a corporation capitalizes itself with debt rather than equity, assuming it is a taxable corporation.

I think that is going to happen as an ordinary course of the operation of the system, whether or not you have an acquisition, even if done through a debt-financed stock repurchase.

Chairman PICKLE. If you have these acquisitions, and there is a deduction of interest that does mean that the Federal Government will be losing revenue, as I see it. And if, in the case of greenmail, the revenue is paid out, is somebody paying interest on those funds?

Mr. BROCKWAY. They are paying interest on the funds they borrow to repurchase the stock and pay the greenmail.

I think the problem isn't generally the deduction of interest. You may wish to discourage certain types of transactions by identifying those transactions and then disallowing the interest on debt incurred in those transactions. It is my view that that is a difficult job to attempt to define the transactions——

Chairman PICKLE. Is someone paying taxes when they receive interest income?

Mr. BROCKWAY. The corporation would deduct the interest payments and it won't pay taxes on that, but the bond holder will include that in income. It depends upon whether the bond holder is taxable or not.

Chairman PICKLE. I want you to submit to the committee—I have listed five or six of the tax incentives that are being used. I want your estimate of which one is being used in more instances.

We have asked Treasury to give us an analysis of 10 of the largest mergers in the past couple of years or so. I want some evaluation from the Joint Tax Committee, from you at some point, as we proceed in these hearings, so we will know a little more about it.

I am surprised to hear you say it doesn't make much difference about deductibility of interest, whether done by the target company or the acquiring company.

Mr. BROCKWAY. In either case, after the transaction is over, presumably they will be filing consolidated returns. So whether it is the target corporation that incurs the debt and pays the interest or the purchasing corporation that incurs the debt to acquire the stock of the targeted corporation, either way in the one consolidated return after the transaction, there will only be a single interest payment and interest deduction.

So the difference, I think, is not a tax difference; rather, it is a difference that if the target corporation incurs the debt as part of the transaction and it is not guaranteed by the purchasing corporation, it may be a less secure debt obligation, what frequently is referred to as a junk bond, but that is not really a tax difference. It is a shorthand way of referring to the security of the bond.

Chairman PICKLE. I have a lot of other questions.

Mr. Rangel.

Chairman RANGEL. The debt is like a joint return. It does not make a difference which side did it.

Mr. BROCKWAY. That is correct.

Chairman RANGEL. When you file the return, the debt is there and you pay less taxes.

You are saying that all these terms that we have been using as relates to tax liability are unimportant whether you are raiders, friendly, unfriendly, victim, or acquirer; those merely concern the intent of the parties. As this issue relates to the tax result, it really doesn't make any difference?

Mr. BROCKWAY. That is correct.

Chairman RANGEL. You also said that it was just a report, but you don't know whether it is valid that the mergers and acquisitions that have been studied. Only in about 25 percent of those have you found the tax factor to be the driving motivating force.

Mr. BROCKWAY. Certainly I believe in the first statement; I don't think that the terminology is important in most situations.

But the extent to which the tax impacts are important factors or the driving factor is a more complicated issue.

One possibility is that the tax results may be the primary motivating factor of the transaction. Alternatively, the tax treatment may be the driving factor in the form the transaction takes. For example, rather than the corporation selling its assets in the ordinary course of business, you may have a corporate takeover.

Chairman RANGEL. Regardless of what factors are involved in the takeover or which method is used to reduce the tax liability, if indeed that is a consideration as opposed to the driving consideration, the witnesses that testifed earlier were really trying to target those mergers and acquisitions which were made primarily for quick profit. In terms of the merger, which disrupt the actual economy of the communities, the so-called victim corporation is decidedly involved.

If you had all of these factors being taken advantage of, the net operating loss, the debt financing, the ESOP's, the step-up valuation, is it not possible that the merger could enhance the economic situation of the new firm as opposed to what was two separate entities?

Mr. BROCKWAY. It is clear that in a number of transactions, regardless of the tax factors, the merger or acquisition might enhance the profitability of the company and be a good thing for the economy.

The question is whether you want the tax rules to artificially induce transactions that might not otherwise occur, whether as the primary factor or just affecting it at the margin.

Chairman RANGEL. I am just saying that if you did put in the tax advantage, I am concerned with how many of these acquisitions and takeovers have been sound, even including the tax advantages that were there, that maybe they would not have merged if it was not for the tax advantage.

Maybe those were the final factors that allowed Macy's to take over Gimbel's and increase the productivity of the firm.

Mr. BROCKWAY. I think the best judge in the marketplace of whether or not the transaction would be sound is what would happen if the decision weren't distorted by the tax laws, if the tax laws did not operate to induce, in whole or in part, the transaction or the form that the transaction occurred.

If you can say that the transaction would have occurred without beneficial tax treatment, presumably the marketplace is saying that transaction will enhance the economic value of the corporation.

Chairman RANGEL. All these provisions are in the Tax Code. Whether we are talking about ESOP's or net operating losses or deductibility of interest, these provisions are supposed to be sound tax policies. There are some people that have taken advantage of and abused them and perhaps they are seeking a goal for quick profit rather than the goals for which the laws were created.

Is it possible that you could suggest to us how we can avoid abuse and at the same time not change the entire way we tax corporations?

Mr. BROCKWAY. I think there are some finite things you can do. The real difficulty is the one you mentioned. Many of these provisions are put in the law for reasons that Congress felt were appropriate, not to encourage mergers or acquisitions that would not otherwise have occurred but, for example, to encourage employee stock ownership or whatever the particular issue might be. It is very difficult to figure out how to limit the incentive effect of those provisions to the transactions that you had in mind without having them also having the undesirable side effect of causing mergers and acquisitions to happen that would not otherwise occur.

Chairman RANGEL. You keep saying mergers and acquisitions like it is a terrible thing. It does not have to be bad, does it?

Mr. BROCKWAY. It does not.

Chairman RANGEL. If somebody takes advantage of an incentive, there is no reason, just because they used it, to talk about banning it. I think we are talking about mergers and acquisitions which

have no real sound economic objective for the society in general and that only a few manipulators profit from it.

Mr. BROCKWAY. That is one viewpoint, simply to limit those transactions that have no substantive purpose other than taxes. I think by and large the tax law may currently operate to stop that type of transaction. I think the question may be broader than that.

For example, the debt versus equity problem arises because you have a higher tax on equity than on debt. It does not arise because you intended an incentive to debt capitalization by providing a deduction for interest.

Chairman RANGEL. We would have that problem if we were not studying mergers and acquisitions.

Mr. BROCKWAY. It distorts the economy in a way. The transactions would not occur, but for these tax effects and the marketplace is saying that, in the aggregate, those transactions are not beneficial.

Chairman RANGEL. Could you say that in cases of mergers and acquisitions, interest on newly acquired debt is not deductible?

Mr. BROCKWAY. That is an approach a number of people have suggested. That turns out to be a difficult thing to do, but possibly you could limit the aggregate amount of indebtedness in certain transactions.

Senator Chafee has a proposal to require a full gain recognition in the case of a transaction where there is a basis step up. Whether you can make that rule work effectively is a question one would have to look at, but certainly that would eliminate what appears to be an unintended inducement to acquisitions in the economy.

Chairman RANGEL. Could you yield for 15 or 20 minutes and give the committee an opportunity to take testimony from Comptroller Harrison J. Goldin from the city of New York who has to return to my hometown. The rest of the Members do have questions.

Would the Comptroller of the city of New York come forward. Let me take this opportunity to thank him for changing his schedule. He was supposed to testify yesterday and that was canceled. We recognize that the Treasury Department is waiting to testify. We take that into consideration.

Thank you for the great job you are doing for the city and therefore the State and the Nation. We appreciate you sharing your views with us today. If you have a prepared statement, that entire statement by unanimous consent will be entered into the record and you may proceed as you feel most comfortable.

STATEMENT OF HARRISON J. GOLDIN, COMPTROLLER, CITY OF NEW YORK, AND COCHAIR, COUNCIL OF INSTITUTIONAL INVESTORS

Mr. GOLDIN. Thank you very much.

I do have a full prepared statement which I am going to submit for the record and I am going to read extracts from it now with copies being distributed to the members.

I appreciate this opportunity to add to the national debate on the appropriate response to hostile corporate takeovers and defensive reactions by management.

I would note parenthetically that I am shifting ground somewhat from the testimony that you heard this morning because I represent an interest for which there are no tax considerations, so I will talk about the proposed kind of responses in terms of congressional action to the corporate takeover and activity that we have all heard about so much in recent months.

Let me give you the bottom line of my view first: We should resist governmental interference in this matter. To the extent possible; Government should stay as far away as it can from the dynamics of the marketplace.

I reach this conclusion as the comptroller of the city of New York, the custodian, trustee and/or asset manager of five New York City pension funds, whose aggregate assets exceed $22 billion. In that capacity, I am, of course, an institutional investor, deploying those assets to secure the highest possile return consistent with prudent levels of risk.

What I and other institutional fiduciaries with like standing confront in today's corporate finance environment is the widening dissipation of assets that belong to our beneficiaries simply to frustrate profiteering by investment bucaneers and insulate management from the risk of displacement.

A principal tactic is the payment of greenmail, which, as you know, is a payoff by management to deter a corporate predator. Too often management is willing to give away assets which ultimately are not its in the first place to induce a corporate raider to get off its back and, thereby, secure its own position and perquisites.

From my viewpoint, such two-tiered treatment of shareholders, whereby value belonging to my pension funds is given away to the corporate raider, should be resisted and rejected.

But I do not think the appropriate response is national legislation to restrict corporate takeover activity in various ways. Why? Because takeovers are not inherently bad in themselves.

Moreover, despite the usually warranted pejorative implications of the term "greenmail" itself, there may be instances in which other shareholders will conclude that a raider should be paid for taking a risk that profits all pari passu.

The issue, in a word, is basically this: When dealing with a public enterprise, whose company is it anyway? The answer? The shareholders'. It is their prerogative to make basic policy decisions about the direction of a corporation.

Legislation to restrict mergers and acquisitions would effectively substitute the judgment of Government for the judgment of shareholders as collective owners of companies. This would frustrate the free market.

Legislation restricting mergers and acquisitions would promote the paradox of restricting the opportunity of shareholders to profit in the name of enabling them to maximize the value of their investments. I want the opportunity to make that judgment myself on behalf of my pension funds and not have it restricted by statute or replaced by the discretion of Government bureaucrats.

To be sure, I and other institutional investors are, in the main, long-term investors whose participation in the Nation's security markets furthers the essential purpose of such markets, namely, to

facilitate capital formation in the interests of growth and a fuller realization of the value of assets. With sizable holdings in literally thousands of corporations our general interest is in the long-term growth of all corporate America. By and large, we invest in management, confident in its day-to-day stewardship, albeit retaining for ourselves the discretion to make fundamental decisions about the deployment of our investment.

But unfriendly takeovers of corporations cannot always be said to divert management from long-term goals that are in a firm's best interests. Neither are short-term profiteers necessarily bad for a company or the economy as a whole. Sharks do not always thwart the market's essential purpose of capital formation and optimal deployment of assets; indeed, at times they fulfill it.

How to reconcile the long-term goals of a company with the potential for shorter term profits is not for government to resolve. Institutional shareholders and individual investors are very capable of evaluating for themselves serious offers from potential buyers and determining whether we want an immediate higher return on our investment, with the option to redeploy our assets for our own benefit.

In a word, should Mr. Pickens, Mr. Icahn, the Bass brothers or others care to hold an open auction for any of the stocks in our pension portfolios, I would not restrain them, nor would I want government to restrain them either.

Government's role should be to prevent and prosecute fraud. Since mergers and acquisitions are not inherently fradulent, even when unfriendly, Congress can rely on the laws already on the books to deal with cheaters.

As to greenmail, last Thursday's Wall Street Journal provided an excellent example of the countervailing forces in the marketplace that offset the greenmailers and sharks. The paper cited 372 bylaw changes proposed by managements last year to deter takeover attempts by raiders and that the total of such management-sponsored proxy resolutions thus far this year is running well ahead of the rate last year.

Some of these measures are simply designed to perpetuate and insulate existing management. I do not like many of them; and when we vote our proxies, we will vote against them. But the point is this: The market is sorting the matter out; and that sorting role ought to be left to us as shareholders and market participants, not to the Government.

Another countervailing force is the newly formed Council of Institutional Investors. As you know, I am one of three cochairmen of this council, with Jesse Unruh of California and John Konrad, chairman of the Wisconsin Board of Investment.

Formed in late January, the council so far consists of 22 pension funds with combined assets totaling over $100 billion, representing 25 percent of the asset value of all public pension funds and nearly 7 percent of the $1.5 trillion estimated to be in the portfolios of all institutional investors, both public and private.

We do not make collective decisions, nor do we delegate our individual fiduciary responsibility to the council. However, we share information, conduct research and analyze proposed takeover attempts and the motives of financiers making those attempts.

While each of us makes his own decisions in the light of his individual pension fund's interests, the mere formation of such a council has generated an intense interest in its activities and a respect by both management and outside acquisition experts for the individual viewpoints of council members.

As corporate assets owned by pension funds increase exponentially in the American economy, the council's role is likely to grow. You can be sure that as institutional investors we will be protecting and asserting our interests increasingly. We have to, because our interests coincide with the economic interests of millions of ordinary Americans whom we represent as fiduciaries. We are not now, nor will be be, afraid of the fat cats and the sharks. We can handle them without the help of the Federal Government.

In sum, be diffident about legislating restrictions on mergers and acquisitions. Do not lightly tamper with the market. The market can likely handle on its own the problem of incompetent managements and aggressive raiders. Laws and other governmental restrictions in this sphere of the free market would constitute an interference that could actually harm the common good.

Thank you.

[The prepared statement follows:]

STATEMENT OF HARRISON J. GOLDIN, COMPTROLLER, CITY OF NEW YORK, COCHAIR, COUNCIL OF INSTITUTIONAL INVESTORS

I appreciate this opportunity to add to the national debate on the appropriate response to hostile corporate takeovers and defensive reactions by management.

In the next century an American historian might devise the following summary of these hearings: "Representatives of the entrenched executive suite defended its perks and sacred cow status against a band of raiders, sharks and greenmailers. Pension fund managers responsible for billions, whose dough was in the mixing bowl, told a Congressional committee they liked neither the effort to secure greenmail nor the poison pill defense. They objected to shark repellants and sweeteners as additives, emphasizing that it was their dough being kneaded by others. They also said that if golden parachutes are to be given out as planes fall, there should be one for every passenger."

But then again future historians might look at the date and conclude that it was all just an April Fool's Day joke.

Indeed, the whole issue might be a joke were it not that megabucks are involved and that much of American corporate management is asking government help to quash, not their activity, but the initiatives of entrepreneurs seeking a quick buck in the marketplace, an instinct, after all, which has been a driving force of capitalism and is as American as apple pie.

Let me give you the bottom line of my view first: we should resist governmental interference in this matter to the extent possible; government should stay as far away as it can from the dynamics of the marketplace.

I reach this conclusion as the Comptroller of the City of New York, the custodian, trustee and/or asset manager of five New York City pension funds, whose aggregate assets exceed $22 billion. In that capacity I am, of course, an institutional investor, deploying those assets to secure the highest possible return consistent with prudent levels of risk.

What I and other institutional fiduciaries with like standing confront in today's corporate finance environment is the widening dissipation of assets that belong to our beneficiaries simply to frustrate profiteering by investment bucaneers and insulate management from the risk of displacement.

A principal tactic is the payment of greenmail, which, as you know, is a payoff by management to deter a corporate predator. Too often management is willing to give away assets which ultimately are not its in the first place to induce a corporate raider to get off its back and, thereby, secure its own position and perquisites.

From my viewpoint, such two-tiered treatment of shareholders, whereby value belonging to my pension funds is given away to the corporate raider, should be resisted and rejected.

But I do not think the appropriate response is national legislation to restrict corporate takeover activity in various ways. Why? Because takeovers are not inherently bad in themselves. Some are, adversely affecting a company's shareholders and the maximization of its assets through orderly long-term growth. But some are good, narrowing the disparity between a company's asset value and the market price of its stock. So there is no ethical imperative to legislate takeovers out of existence or restrict their frequency or scope.

Moreover, despite the usually warranted pejorative implications of the term "greenmail" itself, there may be instances in which other shareholders will conclude that a raider should be paid for a risk taken that profits all pari passu.

The issue, in a word, is basically this: When dealing with a public enterprise, whose company is it anyway? The answer? The shareholders'. It is their prerogative to make basic policy decisions about the direction of a corporation: whether it should or should not be sold; whether it should be taken over or not; whether its management should be retained or replaced. Shareholders like everyone else may make mistakes, and they will get their just desserts; if their decisions are right, they will be rewarded in the time-honored coin of capitalism, profit.

Legislation to restrict mergers and acquisitions would effectively substitute the judgment of government for the judgment of shareholders as collective owners of companies. This would frustrate the free market.

First, no law is foolproof. Any entrepreneur worth his salt has a capacity to find loopholes that is well nigh infinite.

Second, legislation restricting mergers and acquisitions would promote the paradox of restricting the opportunity of shareholders to profit in the name of enabling them to maximize the value of their investments. I want the opportunity to make that judgment myself on behalf of my pension funds and not have it restricted by statute or replaced by the discretion of government bureaucrats.

To be sure, I and other institutional investors are, in the main, long-term investors whose participation in the nation's security markets furthers the essential purpose of such markets, namely, to facilitate capital formation in the interests of growth and a fuller realization of the value of assets. With sizable holdings in literally thousands of corporations our general interest is in the long-term growth of all corporate America. By and large, we invest in management, confident in its day-to-day stewardship, albeit retaining for ourselves the discretion to make fundamental decisions about the deployment of our investment.

But unfriendly takeovers of corporations cannot always be said to divert management from long-term goals that are in a firm's best interests. Neither are short-term profiteers necessarily bad for a company or the economy as a whole. Sharks do not always thwart the market's essential purpose of capital formation and optimal deployment of assets; indeed, at times they fulfill it.

As for attempted takeovers that would damage a company, that might leave it weak, that would dismember it and dissipate its assets, those mounted by corporate vandals concerned only for enriching themselves at the expense of other shareholders, let me and other owners decide what is in our best interests. I would rather trust our judgment that that of even a benevolent government.

How to reconcile the long-term goals of a company with the potential for shorter-term profits is not for government to resolve. Institutional shareholders and individual investors are very capable of evaluating for themselves serious offers from potential buyers and determining whether we want an immediate higher return on our investment, with the option to redeploy our assets for our own benefit.

In a word, should Mr. Pickens, Mr. Icahn, the Bass brothers or others care to hold an open auction for any of the stocks in our pension portfolios, I would not restrain them, nor would I want government to restrain them, either.

Government's role should be to prevent and prosecute fraud. Since mergers and acquisitions are not inherently fraudulent, even when unfriendly, Congress can rely on the laws already on the books to deal with cheaters.

Even as to greenmail, last Thursday's Wall Street Journal provided an excellent example of the countervailing forces in the marketplace that offset the greenmailers and sharks. The paper cited 372 by-law changes proposed by managements last year to deter takeover attempts by raiders and that the total of such management sponsored proxy resolutions thus far this year is running well ahead of the rate last year.

Such countervailing measures include requiring equal treatment for all shareholders in any tender offer; a two-thirds vote of shareholders to approve a corporate buyout; approval by 80% of the shareholders of any merger or removal of a director by an outside buyer; issuance of new stock to dilute the voting strength of outstanding shares; giving present shareholders 10 votes for each share and requiring future

holders to hold their stock for four years to get equal power; staggering the election of boards so that only one-third is elected each year; and on and on.

Obviously, some of these measures are simply designed to perpetuate and insulate exising mangement. I do not like many of them; and when we vote our proxies we will vote against them. But the point is this: the market is sorting the matter out; and that sorting role ought to be left to us as shareholdes and market participants, not to the government.

Another countervailing force is the newly formed Council of Institutional Investors. As you know, I am one of three co-chairman of this Council, with Jesse Unruh of California and John Konrad, chairman of the Wisconsin Board of Investment.

Formed in late January, the Council so far consistes of 22 pension funds with combined assets totaling over $100 billion, representing 25 percent of the asset value of all public pension funds and nearly 7 percent of the $1.5 trillion estimated to be in the portfolios of all institutional investors, both public and private.

We do not make collective decisions; nor do we delegate our individual fiduciary responsibility to the Council. However, we share information, conduct research and analyze proposed takeover attempts and the motives of financiers making those attempts.

While each of us makes his own decisions in the light of his individual pension fund's interests, the mere formation of such a council has generated an intense interest in its activities and a respect by both managements and outside acquisition experts for the individual viewpoints of Council members.

Let me stress again that, as fiduciaries, we do not and cannot act collectively. But clearly, if one of us has good reasons for opposing a management resolution or an outside tender offer, and that one shares those reasons and backup documentation with the other members, others will likely find themselves in the same boat, and independently reach a similar conclusion when the time comes to vote our shares, sell them or buy more.

When the Council met in my Office recently to consider Mr. Icahn's tender offer and management's recapitalization plan for Phillips Petroleum, all the past and current principal in the Phillips takeover effort came to inform and persuade us—Mr. Icahn, Mr. Douce, Mr. Pickens, Mr. Boesky and a delegation from Bartlesville, Oklahoma to present the community's viewpoint.

As corporate assets owned by pension funds increase exponentially in the American economy, the Council's role is likely to grow. You can be sure that as institutional investors we will be protecting and asserting our interests increasingly. We have to, because our interests coincide with the economic interests of millions of ordinary Americans whom we represent as fiduciaries.

The interests of members of the Council will have to be considered closely both by the managements of United States corporations and the financiers who are in the business of taking over businesses. We are not now, nor will we be, afraid of the fat cats and the sharks. We can handle them without the help of the Federal goverment.

In sum, be diffident about legislating restrictions on mergers and acquisitions. Do not lightly tamper with the market. The market can likely handle its own the problem of incompetent managements and aggressive raiders. Laws and other governmental restrictions in this sphere of the free market would constitute an interference that could actually harm the common good.

Thank you.

Chairman RANGEL. How does this council help those corporations that are potential victims that don't have the benefit of the wisdom of the council members?

Mr. GOLDIN. The work of the council isn't designed in the main to help or to harm corporations that may be the subject of takeover. The council is designed to enable its members who are fiduciaries representing a very large number of shareholders to make better informed judgments as to what the interests of those shareholders and the funds we represent are in the face of these proposed mergers or other corporate finance activities.

Chairman RANGEL. You are saying that the free marketplace should work its will and that these other stockholders, if they don't know the intent of the so-called raiders, should rely on their best judgment or rely on what is available at the time?

Mr. GOLDIN. To the contrary, I said that the interests that we represent as public pension funds are identical with the interests of other individual shareholders and since you now have the coming together of this vast power in the American economy, fiduciaries of the kind of which I am one, the interests of individual shareholders are now beginning to be vindicated by a rousing of this leviathan which is represented by institutional shareholders so rather than having the interests of the public pension fund be contrary to the interests of individual investors, the interests are identical and we are able to begin to vindicate those interests in a way that I believe will be effective.

Chairman RANGEL. You don't believe there is a need for change in the legislation?

Mr. GOLDIN. No; the Council of Institutional Investors, having been recently formed representing such a vast potential in terms of an impact on corporate merger and acquisition activity, I think it would be premature for the Congress to act in the face of what I believe is the likely effectivness of this council and institutional investors generally to act within the free marketplace without being constrained by legislation.

Chairman RANGEL. What percentage of America's institutional investors are represented on the council of which you are a member?

Mr. GOLDIN. Represented are 22 funds. The aggregate assets exceed $100 billion and that represents 25 percent of the asset value of all public pension funds. We anticipate that a considerably greater number of public pension funds will over time decide to join.

Chairman RANGEL. We thank you for sharing your views with us. It does give us some balance with the testimony that we have received so far.

Thank you.

Chairman PICKLE. Mr. Schulze, do you have questions?

Mr. SCHULZE. Yes, Mr. Chairman.

Thank you, Mr. Goldin, for your testimony.

I agree with almost everything you said. Are you testifying as comptroller or as a member of the board of this new council?

Mr. GOLDIN. Mr. Schulze, I am what I am. I am the comptroller of the city of New York. I am also a fiduciary for over $22 billion in pension assets myself. I am also a cochair of the Council of Institutional Investors.

Mr. SCHULZE. Let me rephrase my question. Would I be correct to view you as one who is an expert in large funds investing in the marketplace, an institutional investor with a portfolio of $22 billion?

Mr. GOLDIN. I think it is correct to say that I represent one of the largest pension fund systems in America.

Mr. SCHULZE. Thank you.

Is your new council going to rate potential acquistions or mergers? You said this newly found interest will create a greater awareness in institutions. Who is going to be the guard? Who is going to blow the whistle or wave the flag? That is why I asked the question.

Further, are you going to publicize your views?

Mr. GOLDIN. In a word, the answer to your question is that the marketplace is going to be a guardian and pending substantial demonstration over time, especially in the light of a wakening of what I characterize as the leviathan of institutional investors to be active in the area, I think legislation would be premature. We are all trustees and recognize that our individual trusteeship is not delegable to others. As a consequence, the members of the council will come together to inform themselves to take advantage of the fact that we are large and important investors to elicit all information that can be available as to what position each of us ought to take in connection with corporate finance activities and then we will act individually.

The best example may have been provided by the recent Phillips transaction to which there was reference earlier today. In that case, the council asked the chairman of the board of Phillips, Mr. Douce, Mr. Boone Pickens, principal factors in the transaction, to meet with us, which they did, in my office in New York in February.

We listened to what they had to say, questioned them closely. I believe that they came because of what the aggregate assets of this council represented. The members of the council then sat around the table after they had left and discussed among ourselves what we had heard and resolved any differences we may have had in interpretation of the information we had gotten.

We then dispersed, each member to make a judgment about what was in the best interest of each of the pension funds for which we act. I think it not unlikely in such situations that what you would find since we have a common interest as fiduciaries that we would reach the same judgment independently, but we do not reach our judgment in concert.

Mr. SCHULZE. I understand.

It is plausible that judgment over these matters might be influenced by political disruption which might be caused by a merger or acquisition here or there, such as the situation in Oklahoma. I would guess that were I a Member of Congress or a Senator, from there and one of the largest employers in the State was going to be involved, I would almost be forced to get up and say, "We have to do something about this." It concerns me that we might do these things for a political reason rather than let the marketplace control it, as you suggest.

Some of the remedies which have been put forth, in my opinion, will not really solve the problem, but will add another layer to the bureaucracy. If changes are needed in regulation, can they can better be written at the State and/or the local level?

Mr. GOLDIN. No, Congressman, I don't. If what ultimately emerges is that legislation is required, it would seem this would need national attention. I resist the notion that legislation ought to be provided in the first instance.

Mr. SCHULZE. You think we should dictate the makeup of the corporate boards around the country which is now left to the States?

Mr. GOLDIN. I do not. I don't think legislation is required and in the second instance, I said that were it required, it should be national. I don't think that one should conclude from that the ridiculousness of the slippery slope.

Mr. SCHULZE. You don't think if an individual State is concerned that they should act on that level? You are saying you like things just the way they are and don't want anybody to do anything?

Mr. GOLDIN. I don't think that is correct. I indicated I thought the free market would be able to handle the matter without regulation or legislation. I indicated that were it ultimately to develop that the national economy required the issue to be dealt with, that that very focus would likely indicate that it ought to be done through national legislation. That does not mean that one should conclude that the whole area of corporate law should therefore be taken away from the States and dealt with nationally.

The two areas, it seems to me, are very different.

Mr. SCHULZE. Most of the legislation that is before us puts most of the decisionmaking power in the hands of the independent trustees or members of the board of directors on the various corporations. This can be accomplished if we legislate that control nationally. You talk about a slippery slope, but I think that is a dangerous quagmire for us. If regulations are going to be written, I think they should be done at the State level.

I see my time has expired.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Flippo.

Mr. FLIPPO. Mr. Goldin, I appreciate your opinion in many areas. You make your point, I get your message that you would just as soon Government not, I believe you used the word "interfere" in this area, that the market will make that evaluation. The market, to the extent that there are tax advantages that come about as a result of these mergers and acquisitions, the market, of course, capitalizes those tax advantages, and so the tax advantages are reflected in the stock price; would you agree with that generally?

Mr. GOLDIN. I would say that that is generally true. I would point out that, of course, I represent a fiduciary for whom the tax considerations are negligible and therefore we are affected by tax considerations only indirectly to the extent that the values that we hold are affected by tax considerations in the marketplace.

Mr. FLIPPO. But tax considerations are reflected in the market price and you are certainly interested in the market price.

Mr. GOLDIN. That is correct.

Mr. FLIPPO. So you wouldn't disagree that it would be the responsibility of this committee to determine how much of the taxpayers' money it would be willing to invest in these increased mergers and acquisitions through the tax advantages—that would be a proper role for this committee, I believe you would agree?

Mr. GOLDIN. Clearly a proper role for this committee is to make judgments on tax policy generally, including those relating to mergers and acquisitions.

Mr. FLIPPO. So to the extent that the tax expenditures of the American taxpayer have an important role to play in the stock prices, then the committee rightfully should examine how much it is willing to invest in those activities.

Now, I would assume that since it is negligible that you would not object if this committee deemed or attempted to make neutral the Tax Code in regard to mergers and acquisitions?

Mr. GOLDIN. I would just point out to you, Congressman—and the members of this committee are far more expert on these matters than I—that to try to adjust tax policy that has broad implications in the economy and on corporate finance generally to a specific situation which requires a judgment about motive and intent in individual cases is a very difficult thing to do in application, but I certainly do not question the authority of this committee to do so.

Mr. FLIPPO. Well, that is the difficult decision that we have to make, since we do have the problems of designing a Tax Code that is either neutral or provides some advantages. I would again ask the gentleman if he would object to this committee designing a Tax Code that is neutral in regard to mergers and acquisitions?

Mr. GOLDIN. Frankly, I don't think the tax policy is ever neutral.

Mr. FLIPPO. Would you disagree with the motive or the intent?

Mr. GOLDIN. As I indicated a minute ago, I think that it is entirely within the prerogative of this committee to determine tax policy as it relates to mergers and acquisitions.

Mr. FLIPPO. I understand.

Thank you very much.

Chairman PICKLE. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

Welcome, Mr. Goldin.

Can I surmise from your testimony that based on a long-term investment perspective you think that the recent activity in mergers and acquisitions has been good for the economy and for your pension funds?

Mr. GOLDIN. Well, as I indicated, Congressman, I think that some mergers and acquisitions are good, some are not good. I do not think that they are so pervasively bad that they ought to be outlawed, or severely restricted, or regulated and I believe it is best left to the judgment of the market as to which are good or bad.

Mr. MCGRATH. Have you ever voted against an acquisition of a company whose stock your retirement fund owned?

Mr. GOLDIN. Unfortunately, in too many cases the opportunity to vote as a stockholder is not submitted to shareholders. That is something we hope to be active to remedy and remedy through our prerogative as a large shareholder.

Mr. MCGRATH. Is it safe to assume that since your retirement fund is tax exempt, the tax considerations of mergers and takeovers doesn't affect your decision whether you buy or sell any particular stock?

Mr. GOLDIN. That is correct.

Mr. MCGRATH. I have no further questions, Mr. Chairman.

Chairman PICKLE. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Goldin, in one of your paragraphs it says:

> Should Mr. Pickens, Mr. Icahn, the Bass Bros. or others care to hold an open auction for any of the stocks in our pension portfolios, I would not restrain them nor would I want Government to restrain them either.

In other words, I take it from that paragraph that you think these investors should be totally unfettered and should be able to go in and out of the marketplace after any company they want.

Mr. GOLDIN. I think the more precise formulation is that I do not believe in the face of the rising ability of institutional investors in the marketplace to respond to such activity that the blunt instrument of legislation or governmental regulation is the appropriate response. I think these issues are best left to the marketplace.

Mr. ANTHONY. Would you also put stocks and energy companies in that same category?

Mr. GOLDIN. Yes, sir, I would.

Mr. ANTHONY. Let me set up a scenario for you. All of the people just mentioned, plus numerous other investors, get together and decide that they are going to take over every single oil company in the United States and in fact they do, and they use leverage buyouts to do it. This makes them successful and able to take over all the oil companies, but they strap them with so much debt that they have no ability to do anything other than to repay the debt. Therefore all domestic, offshore, tertiary, and alternate sources of seeking for additional energies are shut down.

And then all of a sudden, our OPEC suppliers decide that, hey, we don't believe we want to send any more oil to the United States at the current price. The companies have also said, "Well, we don't have any ability to make any money so let's shut down our refineries." All of a sudden, there is an oil embargo so we say we have a lot of oil in the salt caverns in Louisiana. We pull it out and refine it, and the Government looks around and says, the Bass Bros. just shut down all the refineries in the United States, so we don't have gasoline or diesel fuel available. Maybe we can buy some overseas so that we can get our jet planes off the ground or get our tanks running."

Do you see anything wrong with this?

Mr. GOLDIN. I think you have made a strong argument for an expansion of governmental expenditures to stockpile the oil reserve.

Mr. ANTHONY. Why stockpile the oil reserve if you can't refine it?

Mr. GOLDIN. You have demonstrated that in order to be able to control such a risk, the Government has available to it other remedies in other areas which it should exercise.

Second, your hypothetical, which is an intriguing one, raises the specter of other governmental policy, antitrust policy. You posited a situation which might represent a conspiracy——

Mr. ANTHONY. You say hypothetical. Ask Union Oil what they are projecting to do with their domestic drilling program in the face of the current problems that they have. A reasonable expectation is that what they find will be a slowdown. I challenge you to look at some other oil companies and see what their drilling activity is as a result of some of the debt that has been laid upon them.

The moneys that would have gone into exploration and development will be transferred someplace else. That is not a hypothesis. That is something which is happening now. The hypothesis and the ridiculous situation I laid out is to show that some of those people might do such a thing.

I mentioned the absurdity of that situation to see if there was anything in this situation that shocked your conscious. Maybe you noticed some national public policy that overrides just having a total market operate with no Government intervention whatsoever.

Mr. GOLDIN. There may be, but I haven't heard it. It seems to me that the answer to the potential situation is not to insulate corporate management from the exposure of the marketplace, which is the offsetting proposal that is implicit in the point of view that I hear from you. I believe that it would be a grave mistake to say to corporate management that because there is a national interest in stability in corporations, that therefore corporate management no longer has to worry about the risk of the marketplace representing a threat to its hegeomony, I think that is a grave mistake.

I suggest that the marketplace is an adequate instrument even in the energy industry for assuring that the forces of competition will serve the national interest. If it develops that that is not true in the energy industry and that there is an overriding national need, I would suggest that there are other governmental policies that can deal with that matter.

You have posited effectively a restraint of trade that could be the subject of antitrust regulation. I wasn't being flip when I said that.

Mr. ANTHONY. On the bottom of page 4, you are talking about institutional investors going in for the main long-term investments. In other words, you consider yourself to be an investor, confident in the day-to-day stewardship and looking for the long-term situation. I wonder if you could address a concern that I personally have had and that many of my constituents have also expressed to me, and that is to what extent do pension plan investors churn stocks looking for short-term gain?

I wonder if you could submit what your record is on the pension fund that you oversee. In doing that we could see just exactly what the activity is and how many churning effects you have been involved with. We could also do the same with other pension fund managers.

Mr. GOLDIN. I would be glad to do that. I think you would find that we are long-term investors, take very large positions in very large companies. We hold our stock for meaningful periods of time. Our interest is not a short-term profit. It is the performance of the market over the long-term and over market cycles, therefore, we have a great interest in the performance of the economy generally and the pension funds which I serve, for example, we hold well over a thousand stocks.

I would be delighted to give you specific information which I think will reassure you that we do not look for short-term trading swing profits, although obviously we are interested in the maximization of the assets in our portfolio over the long term.

Mr. ANTHONY. There are two things that I think would be beneficial for the committee to have in order to establish the record. First of all, what is the history of churning versus the history of the long-term investment. Secondly, if you have any stocks that you have owned and you have had to participate in a merger or acquisition, either a hostile or friendly takeover, what is the history of this. I think the answers to these questions would be beneficial in seeing how large a role an institutional investor plays in a takeover.

I would like to close by asking about ESOP's. I want to know if you have any concerns, and if so, what they are in view of the recent use of ESOP's in mergers and acquisitions?

Mr. GOLDIN. In the main, Congressman, I welcome the trend toward giving employees a greater stake in corporate America and allowing them to have ownership positions in the corporations for which they work. I am troubled by the use of an ESOP as, for example, in the Phillips Petroleum matter simply to frustrate the ability of the corporation to have available ultimately the potential to sell a controlling interest as an asset that belongs to shareholders.

If employees become owners in the corporation because they have paid for their stock in one way or another, the same as other shareholders, I think that is a welcome development and a desirable trend.

On the other hand, in the Phillips transaction, the program was in effect to transfer a very large position in the company to employees quite obviously in order to frustrate the potential of other existing shareholders to be able to sell a majority interest in that corporation to another investor at some point. That potential, as I see it, represents an asset which belongs to shareholders.

Mr. ANTHONY. In 1984, we made very substantial changes in the law in ESOP's. Have you seen or can you detect any increase in the use of ESOP's within the current merger mania?

Mr. GOLDIN. No, I haven't particularly noted any substantial increase. The most dramatic recent example that I indicated was the Phillips matter and I characterized my view on that a moment ago.

Mr. ANTHONY. That was more of a defensive mechanism for management in warding off a raid.

Mr. GOLDIN. That is correct.

Mr. ANTHONY. It is a reverse of what I am talking about. It is one of the other mechanisms that management is using.

Mr. GOLDIN. I think it shows the great risks implicit in regulation because a development which I suspect you and I both applaud—I think one can conclude that we both favor the idea of employees having a greater ownership position in a corporation—Phillips dramatized that even a beneficent development can be used by management in a way that perverts that was intended.

Mr. ANTHONY. Thank you.

For someone who comes from the State of Arkansas and says that they would rather depend upon the marketplace than a benevolent government, I hope you keep the city affairs of New York City on a real sound basis.

Mr. GOLDIN. We try to. I don't think the world is monolithic. A policy that applies sensibly in one area may not be a policy that should be mindlessly applied elsewhere. So in the same way that the Congress applies its good judgment in giving assistance to other places around the country, I hope it will do so where it makes sense and not mindlessly conclude that the Congress should be sticking its nose into every tent even where it is unwarranted.

Chairman PICKLE. Mr. Goldin, thank you for your testimony. I was out of the room for a portion of your statement. As I understand, one member had asked you the members of your organization. Can you tell me, how many different organizations are a member of your organization?

Mr. GOLDIN. There are 22 public pension funds that are members of the Council of Institutional Investors.

Chairman PICKLE. Is it a California nonprofit mutual benefit corporation?

Mr. GOLDIN. That is correct.

Chairman PICKLE. I understand you have assets in excess of $100 billion; is that generally correct?

Mr. GOLDIN. The members of the council represent assets that exceed $100 billion, That is correct.

Chairman PICKLE. Prior to your appearance here this morning, Senator Proxmire made a statement, I want to read part of his statement so you will have background on what he said. He said he:

> Has increasing concern about the short-term orientation of American management in an ever increasing competitive global environment. This short-term focus is enhanced by the pressures of a security marketplace dominated by institutional investors and pension fund managers whose performance is measured on a quarterly basis and who demand virtually instant gratification in order to retain their portfolio accounts.
>
> Today, money managers control an estimated 60 percent of corporate stocks and bonds with more than $1 trillion in holding. As a result, they have a big impact on the price of company stock.

That statement was made earlier by Senator Proxmire. What response would you care to make to that?

Mr. GOLDIN. As you know, Mr. Chairman, the securities markets are made up of many different kinds of interests with many points of view. I think it fair to say that public pension funds in the main are long-term investors with a long-term investment view. We are not short-term traders. One of the indications of that, for example, is that the largest single aggregate of common stocks in the portfolio of the New York City retirement systems are in an index fund. We are investing in the American economy, in the direction of the economy.

As a consequence, it is not accurate to say that from the standpoint of large public pension funds, the investment framework is short term or involves the maximization of profit over a short-term basis. That is not true.

Chairman PICKLE. It can be short or long and I don't guess you care one way or another. You are nonprofit, you don't worry about capital gain. You can take the market or leave it, come in and out and it is no concern of yours as long as the market is to your liking. So it is not critical to you, is it?

Mr. GOLDIN. Not from a tax standpoint, but from an investment standpoint. When we buy stock, we take large positions in the companies in which we buy stock, therefore, it is not practical to move in and out on a short-term basis. If we did, we would disrupt the market. As a consequence, when we buy stock with a company, it is with a long-term investment framework in mind, not with a view to short-term profit, leaving the tax considerations out of the picture completely.

Chairman PICKLE. What is your organization's position with respect to greenmail?

Mr. GOLDIN. As I indicated earlier, and I think it is true of many of the members of the council individually, I believe that we need to resist two-tier treatment of shareholders as represented by greenmail, but I indicated that because I do not believe that mergers and acquisitions is inherently bad, I do not think the desirable

solution is governmental regulation. I believe it ought to best be left to the marketplace to determine in an individual instance whether a specific merger or a specific acquisition ought to be accepted or rejected.

Chairman PICKLE. We had reports that indicate that the impetus for your council's formation was related to institutional investors' outrage over the growing number and size of greenmail payments.

Mr. GOLDIN. That is correct.

Chairman PICKLE. What is then your position now on greenmail?

Mr. GOLDIN. As I indicated to you, I oppose legislation which would restrict greenmail. I believe that it is far better left to the marketplace to deal with all of these instances, even those that involve corporate abuse.

Chairman PICKLE. Do you oppose or feel neutral about any recommendation imposing an excise tax on greenmail profits?

Mr. GOLDIN. As I indicated earlier in response to a question from Mr. Flippo, I believe that the question of tax policy is one that is best left to the discretion of this committee. From my standpoint as a fiduciary, tax considerations are not relevant in the main to our investment decisions, but I think it is appropriate that this committee reach a judgment as to whether it will tax the profits that investors reap, including those commonly called raiders.

Chairman PICKLE. Do you think the greenmail payments should be deductible by target corporations? Would you take a neutral position on that?

Mr. GOLDIN. I have no opinion on that, Mr. Chairman.

Chairman PICKLE. That is much the same thing, isn't it?

Mr. GOLDIN. As a neutral position—I indicated to Mr. Flippo I don't think there is such a thing as a neutral tax policy.

Chairman PICKLE. Since you do not think the Tax Code is neutral now on these mergers—you just said it is not neutral, it would be our prerogative to take action?

Mr. GOLDIN. Correct.

Chairman PICKLE. That is very kind of you.

Mr. GOLDIN. You solicited my view, I gave it to you.

Chairman PICKLE. Are your pension funds involved in financing raiders such as Mr. Pickens or Mr. Icahn?

Mr. GOLDIN. No, sir.

Chairman PICKLE. Have you had any funding of either one of those operations?

Mr. GOLDIN. No, sir.

Chairman PICKLE. I just picked out two out of the air. Have you had something to do with some of the other raiders?

Mr. GOLDIN. No, sir.

Chairman PICKLE. So you haven't been involved with any raiders yet?

Mr. GOLDIN. Not yet.

Chairman PICKLE. Yet.

Mr. FLIPPO. Would the Chairman yield?

Chairman PICKLE. I yield to the gentleman.

Mr. FLIPPO. This witness in particular might be in a unique position to answer this. Since you are interested in the long-term as well as short-term, I wondered if you would tell us, do you have any concerns about the buildup of debt or could perhaps you tell us

what is the proper level of debt to equity ratios or are you concerned about the increased debt that comes in mergers?

Mr. GOLDIN. Clearly there is reason to be concerned about excessive debt in individual corporate situations. I don't think one could give a monolithic answer as to what is an appropriate ratio between equity and debt because the situation varies so much from entity to entity, industry to industry, a lot relates to cash flow, to the cyclical nature of an industry.

The factors are many and, therefore, I don't think one could give an overall answer that would apply to corporations in the main.

Chairman RANGEL. Mr. Chairman, may I ask you to yield again?

I gather, Mr. Goldin, that many things that you find which are abuses of the system as it presently exists and that you have a deep concern for as to balance between equity and debt. I assume the major difference that you may have with members of this committee is that you don't believe that changes in the Tax Code would be the best way in order to get rid of these inequities?

Mr. GOLDIN. I would put the issue just a little differently. I think that there is a distinction between trying to regulate corporate finance activity from the standpoint of a judgment as to whether it is desirable or undesirable, and trying to use the Tax Code as an instrument to do so. And I would argue, since the chairman solicited my view before as did Mr. Flippo, that this committee clearly has the prerogative—the issue of tax policy, it seems to me, ought to be distinguished although they obviously are interconnected from the issue of corporate finance regulation, and if this committee were to determine that for reasons of tax policy, to generate revenue or for other reasons, it wished to impose or reduce or eliminate taxes, that would be one matter.

I argue that it is not in the interest of the country at this time for there to be congressional regulation of the kind of corporate finance activity that we are seeing because I believe that the effect would be damaging to the American economy and because, at the same time, I believe that there is a growing force of likely effectiveness that is emerging which I believe will in all likelihood deal with this issue better in a free market economy.

Chairman PICKLE. Mr. Goldin, I know you have to catch a plane and we are not going to hold you any longer, so we will excuse you.

Let me make a parting statement to you, though, that we, the Congress, are not looking for some more business. The question of mergers and acquisitions is now becoming so large that I said earlier it is the hottest game in America now. Whether it is right or wrong, good or bad, is something that we have to be concerned about because if the Tax Code is being used to encourage these mergers and acquisitions, then we need to establish that. We are not certain that is a fact.

Some people say that institutional investors are causing these big mergers and we don't know whether that is a fact. It might be part of the problem, too, but we must look into it. To ignore or to say we should let the system take its own course is not being practical at this point.

When the Federal Reserve Board and when some of the biggest investors in America are coming to us and saying we are spending all our time worrying about takeovers, it is not time for the Feder-

al Government to wash its hands and look pious. We have to be concerned with whatever is involved.

I submit that we are concerned about how the Tax Code is being used and I don't think you are concerned about it myself. You don't have to be. You don't care whether it is short or long term capital gain or what happens to a company. You get yours and then you can get in and get out. Maybe that is a bit selfish, but there are two ways to look at this thing.

We must look at it positively and find out if there is something we can do or should do. We haven't come to a conclusion that we should, but we are going to look for a way to do it if it seems reasonable.

Mr. GOLDIN. You are right. There is enormous interest in mergers and acquisition. I think it is the kind of issue that thoughtful citizens as well as the Congress should be monitoring closely and these hearings from time to time will be productive and useful.

I differ with the chairman about my perspective as an institutional investor. It is not accurate to say we have no interest about the debt position of corporations. When we buy stock we are very much concerned about corporate capitalization, cash flow, tax considerations as the corporations relate to investments. That, of course, stands in distinction from our narrow lack of interest in tax considerations directly to the pension funds insofar as our purchases and sale of securities are concerned.

But as a major American investor, we have a deep interest in the effect of the Tax Code on corporate America because it affects the direction of the economy, the performance of the economy, and the viability of our investments.

Chairman PICKLE. Thank you, Mr. Goldin.

[The following was subsequently received:]

COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC, May 21, 1985.

Hon. HARRISON J. GOLDIN,
Comptroller, City of New York,
New York, NY.

DEAR MR. GOLDIN: Thank you for appearing as a witness at the Subcommittee's hearing on mergers and acquisitions. Your experience and expertise provided the Subcommittee with much valuable analysis and information. For the purpose of completing the Subcommittee's hearing record, I have enclosed a series of additional questions for your response.

I would appreciate your review and response to my office by June 3, 1985. If you have any questions, please contact Bill Cunningham of the Subcommittee staff at 225-5522.

Sincerely yours,

J.J. PICKLE,
Chairman, Subcommittee on Oversight.

Enclosures.

1. The Council members, the majority of whom represent public funds, have combined assets of more than $100 billion. Is this correct? Who are the members of your organization? What types of public funds are represented?

2. We understand that the Council has announced its goal of obtaining information that will enable the members to better protect the interests of their pension funds. What tax-related information are you gathering?

3. What effect does the ability to terminate overfunded pension plans have in mergers and acquisitions? Does the Council have any specific concerns or proposals in this area?

4. It has been reported that the Council was not formed to oppose takeovers, but to assure that management actions are not taken at the expense of shareholders. What types of management action (or inaction) concern you?

5. According to its by-laws, the Council was organized in June 1984 for the following purposes (In addition to others):

To study, on a non-partisan basis, existing or proposed federal, state, or local legislation or regulations affecting institutional investors and their beneficiaries.

To recommend to general members positions on legislative, administrative, and regulatory actions affecting institutional investors and their beneficiaries.

Is this correct? What conclusions or positions have you reached so far?

6. To what extent have members of the Council purchased junk bonds? To what extent are investments in junk bonds attributable to corporate financing to raise capital? To purchase stock? What percent of your members' portfolios, on average, is attributable to junk bond purchases?

7. How long do your members typically hold stock? How much turned over in the last 2 months? In the last 6 months? In the last 12 months? In the last 2 years?

CITY OF NEW YORK,
OFFICE OF THE COMPTROLLER,
New York, NY, July 10, 1985.

Mr. WILLIAM CUNNINGHAM,
Committee on Ways and Means,
Longworth Building,
Washington, DC.

DEAR BILL: As we discussed today, I am sending, for inclusion in the Sub-Committee's record, additional information with respect to the activities of the Council of Institutional Investors requested by Chairman Pickle. I have also attached a copy of the questions to which these answers respond. A more elaborate presentation has been prepared with respect to question 7. Since the individual in charge of our Asset Management area is currently out of town, I will confer with him to cause this information to be sent to you as early as possible.

Thank you for your patience.

Very truly yours,

JOSEPH F. MOSS, *Special Counsel.*

Enclosures.

1. Yes, when the Council of Institutional Investors was created in January of this year, its original twenty-two member pension funds possessed aggregate assets in excess of $100 billion. The current members of the Council are listed on the attached schedule.

As you will note from the attached schedule, by and large, the Council is presently comprised of public pension funds. Recently, several Taft-Hartley funds, college endowment funds, and private foundations have expressed interest in joining.

2. The Council members are tax exempt pension funds. Consequently, to the extent that they are interested in tax related information, this interest derives from the effects of tax policy on the investment of their assets. Information gathered for the members by the Council secretariat are responsive generally to other concerns, particularly to issues of corporate democracy rather than tax-related information.

3. The existence of overfunded pension plans in recent times has created an additional asset on the books of certain corporations which have made them more attractive as potential takeover candidates. There are many such "hidden assets" and the Council has had no specific discussion with respect to overfunded pension plans.

4. The Council has had the opportunity to date to meet on several important issues involving management actions. The most recent meeting was at Harvard University where the issue of "poison ills" was discussed. Prior to that meeting, the Council met on the complex restructuring involved recently with respect to Phillips Petroleum. It is contemplated that the Council in the near future will meet on the proposed change in the New York Stock Exchange listing requirements which would permit the listing of shares with diluted voting rights.

5. As mentioned earlier, although its by-laws endowed it with greater authority than its members may choose to exercise from time to time, the point which was made in the Comptroller's testimony bears repeating. The point is that individual Council members, as fiduciaries themselves, are not free to delegate those responsibilities to the Council. Consequently, although Council members may share a perspective or a particular interest, they do so as individual funds. The members have, to date, not chosen to speak through the Council but instead have used it as a vehi-

cle to better inform themselves. That having been said, individual Council members such as the New York City Pension Funds which are represented by the Comptroller are quite public in their expression of concern over management actions which do not adequately represent interest of individual shareholders.

6. Members of the Council have, to date, not exchanged lists of their holdings. As for the New York City Pension Funds which represent in aggregate $23 billion, these funds have not been invested in junk bonds issued to finance corporate takeovers. We are not personally aware of any members' funds having been financed in recent takeover activity. You should be aware that the New York City Pension Funds are prohibited from investing in fixed income securities rated less than investment grade. This prohibition is not rare amongst institutional investors and would prohibit the purchase of junk bonds.

PRELIMINARY MEMBERSHIP LIST AS OF JANUARY 1, 1985

California Public Employees Retirement System.
California State Teachers Retirement System.
Connecticut State Pension Fund.
State of Delaware Employees Retirement Fund.
Food and Commercial Workers Union Pension Fund.
Los Angeles City Employees Retirement System.
Los Angeles Fire and Police Pension System.
Massachusetts Pension Reserves Investment Trust Fund.
State of Michigan Retirement System.
Minnesota State Board of Investment.
Navy Relief Fund.
State of New Jersey Division of Investment.
New York City employee pension funds (5 funds).
Sheet Metal Workers National Pension Fund.
Washington, D.C. Retirement Board.
Washington Suburban Sanitary Commission Pension Fund.
State of Wisconsin Board of Investment.

Mr. SCHULZE. Mr. Chairman, before the next witness, may I ask unanimous consent on behalf of Mr. Vander Jagt that his opening statement be placed in the record.

Chairman PICKLE. Without objection, it will be included.

Now I am going to ask Mr. Brockway to come back. Some of the members did not have a chance to ask questions. I would like you to resume your position at the witness table and then I want to inquire whether Mr. Pearlman is here.

Mr. Brockway, please take up where you stopped.

Mr. BROCKWAY. I believe we were in the process of questioning and I assume it was up to Mr. Flippo at this point.

Chairman PICKLE. Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

We have heard a lot of talk about mergers resulting in excessive debt to equity ratios. I want to know whether or not the joint committee has an opinion on what is a proper debt to equity ratio. Are you familiar with any IRS studies on the debt to equity ratios?

Mr. BROCKWAY. There has been a lot of concern about the question of debt to equity ratios because of the tax differential between the two. As you are aware, that issue and the attempt in regulations under section 385 to define the differences between the two has been very controversial over the last 10 years. I guess in answer to what the appropriate level is of debt versus equity, I think it varies from company to company.

I don't think you can come up necessarily with one hard and fast rule. It depends on the facts. Presumably it is the level of debt to

equity that exists if you did not have a distortion created by the Tax Code, that is, treating equity less favorable than debt.

Mr. FLIPPO. In your table, you show how a shift from equity to debt financing can increase the return on investment to an investor, and the market then capitalizes that, and so the Tax Code to the extent that we afford tax advantages in these mergers, it is reflected in the price of the stock through capitalizing the stock values.

Mr. BROCKWAY. I believe that is correct.

Mr. FLIPPO. And then so the American taxpayer does have an investment in these, and I guess we are talking about whose interest are we trying to protect, who are we looking out for. I think everyone is interested in protecting the American taxpayer. What does the American taxpayer get out of these mergers and acquisitions for his investment through tax advantages?

Mr. BROCKWAY. Well, I suspect that insofar as these transactions are influenced by the tax results, probably nothing. Insofar as the transactions would have gone forth in any event, they may well increase the aggregate value of the companies doing business after the merger. Insofar as they would not have gone forward, I think there is probably a detriment. The difficulty in attempting to go to a more neutral tax system is that you may have to make changes that are more far reaching than you would like and have side effects such as revenue loss that you don't wish to entertain.

Mr. FLIPPO. Is there some quantifiction you can put on how far you can extend debt to equity? Is that a factor of what the interest rates are and what the pretax return on investment is?

Mr. BROCKWAY. It is a factor of what the interest rates are and what the yield is inside the corporation. I think clearly another factor is what portion of the economic income of the corporation is currently taxable, because it will only effectively want to incur enough debt for tax reasons to shelter its taxable income. It may well vary depending on whether the corporations are publicly or privately held. In a privately held and controlled corporation, the shareholders are frequently in a much better position to maximize their situation to eliminate the tax totally, that is, to put in enough debt to eliminate it. They are the same investors as the equity holder is, so you are not really increasing the risk so much.

Mr. FLIPPO. Would you comment on the Treasury proposal to permit 50 percent deduction for dividends and its impact on tax advantages in mergers and acquisitions?

Mr. BROCKWAY. I believe that the Treasury proposal would have a meaningful effect in reducing some of the biases in the tax system toward debt financing. I think there are other changes that you could make that would be complementary to those changes as well that might also have that effect.

Having said that, there are also significant consequences from doing so. For example, the proposal of the Treasury to allow a 50-percent dividends paid deduction after 3 or 4 years results in revenue loss of something on the order of $30 billion a year, so that there are clearly competing objectives involved.

Mr. FLIPPO. One final statement, Mr. Chairman.

We have been struggling with if and to what extent the Tax Code encourages these mergers and acquisitions. Does the joint

committee have—has the joint committee studied any examples of a merger in which it had negative tax advantages and they went forward with it anyway?

Mr. BROCKWAY. I am certain that we could come up with transactions that went forward despite tax disadvantages. Ordinarily, the way our tax system works is that we only tax realized gains, and unrealized appreciation isn't taxed until you sell. There is therefore, a built-in bias against the disposition of assets. Thus it is clear that assets are frequently transferred notwithstanding that built-in adverse bias of the system.

So there are many transactions where there was no tax advantage involved whatsoever and they are still going forward with the transaction.

Mr. FLIPPO. Thank you, Mr. Chairman.

Chairman PICKLE. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

Let me see if I can reconstruct some of the testimony and then ask one or two questions.

In your testimony, you contend that the double taxation at the corporate level causes an awful lot of the problems that we have in terms of mergers and acquisitions. You also say that the characteristics of companies that are likely targets might be those who have higher than normal corporate tax rates, lower valuation of taxes as it compares to its stock value, and perhaps, those with large cash assets; am I correct so far?

Mr. BROCKWAY. Basically, yes. I am just not sure in fact those conclusions you drew reflect what is actually taking place. We haven't studied it to know whether the potential takeover candidates are the high tax companies. Looking at the Tax Code, you would think they would be, but I don't have data that will support that supposition.

Mr. MCGRATH. You have also testified that some of the tax code preferences that might mitigate for a merger or a takeover might be the deductibility of interest, the issuing of so-called junk bonds, transfers of net operating losses, and various and sundry others. I think you also have said that the deductibility of interest on debt probably would be the most significant of those. Am I correct so far?

Mr. BROCKWAY. Or—conversely, not so much the deductibility of interest on debt, but failure to allow relief for dividend payments so that dividends are taxed more highly than interest payments.

Mr. MCGRATH. And in an attempt to protect themselves, managers of companies that are targets would seek to establish tax preferred employee stock ownership plans.

Is that one method of protecting yourself?

Mr. BROCKWAY. I understand that was the idea, for example, in the Phillips' transaction and perhaps some others.

Mr. MCGRATH. What were the tax preferences for the establishment of these? How would that work?

Mr. BROCKWAY. If I understand what was contemplated, for example, in the Phillips' transaction, how it might work using an ESOP in a defensive strategy, the objective would be to use the tax benefit credited by the ESOP to stimulate employee ownership.

The ESOP can borrow and only half the interest it pays is taxable to the lender, so there is a low-interest rate on the ESOP financing.

The strategy is that if you can get a sufficiently large block of stock into the hands of the employees, presumably, as in the proposal in the Phillips' case, presumably they will be less likely to vote in favor of a hostile takeover from an outside party than the public stockholders. I think that is what——

Mr. MCGRATH. I am getting at just what the tax implication might be there.

Mr. BROCKWAY. In essence, the tax implication is that the transfer of the stock to the employees, to ESOP on behalf of the employees, is financed by the reduced interest rate because it is——

Mr. MCGRATH. One other mechanism we have heard a lot about today is greenmail. As I understand it, the greenmail is the reacquiring of stock from somebody who wants to take over your company, whereby the acquiring company is paid a higher price for its stock than other stockholders.

Is the cost of borrowing money to reacquire your own stock a deductible item, a business deduction, and if it is, to what extent? Is deductibility based on the entire cost or is it the cost between the regular stock value and the higher value of the stock?

Mr. BROCKWAY. The interest you pay on the debt incurred to buy back your stock is deductible.

Mr. MCGRATH. For the full amount?

Mr. BROCKWAY. The full amount of the interest you pay.

The problem on greenmail, or at least one potential problem on greenmail that exists there, that does not exist with respect to other stock repurchases, is that the corporation not only says it is entitled to deduct interest on the debt, but it may also say that it is entitled to deduct part of the payment to repurchase the stock.

Some taxpayers evidently are taking the position that they are entitled to deduct the differential between what the general market price of the stock is and what the price is, the premium they are paying, and others evidently are taking the position that they are entitled to deduct the entire amount.

Now, there is some real question when either position is valid under present law, but I gather that some taxpayers may be taking that position.

Mr. MCGRATH. I guess that is a question I will have to address to Mr. Pearlman.

I have no further questions, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. McGrath.

Mr. Brockway, I want to thank you for the pamphlet that the Joint Tax Committee has prepared for our use.

I understand you spent some time on that, and the pamphlet has been very helpful to many of our members. They have mentioned it to us and it will continue to serve a very useful purpose as we look further into this question.

We must move along, but I want to ask one question of you. Could the Tax Code—I didn't say "should" but "could" the Tax Code—distinguish between hostile and friendly mergers?

What problem do we have in doing so? Should we make that distinction?

Mr. BROCKWAY. It would be very difficult to differentiate as a general matter between hostile and friendly takeovers.

Whether you wish to or whether you should is really a matter of not so much of tax policy but a matter of general public policy, whether you feel that such a distinction should be made.

Some of the changes that you might consider in the mergers and acquisitions area that I mentioned earlier and pursuant to your request, will identify in further statements, would if made, basically operate to limit some of the benefits in a hostile situation, but not necessarily limit the benefits so much in a friendly takeover situation.

Chairman PICKLE. If we are losing Federal revenue because of these mergers and acquisitions, it doesn't matter much whether it is friendly or whether it is hostile, I guess, in the overall viewpoint.

If it is friendly, and since 70 percent of them are friendly, we are losing more through the friendly mergers than we are through the others, so I think we have got to approach it from the standpoint, how is the tax code being used? What incentives are being used towards these mergers?

When we make a good analysis of that, perhaps we are in a better position to make some decision as to what we should do as a committee. That is why I asked originally, I wish you would list for us the number of tax incentives that exist out there, the principal ones, and how many of them are being used or have been used in some of the mergers that have taken place. That information would be helpful to us as we go along.

Mr. Schulze?

Mr. SCHULZE. Yes, Mr. Chairman. I am sorry that I have been in and out and missed questioning Mr. Brockway earlier.

But, Dave, I have just a couple of questions on the mechanics of acquisitions.

If Company X decides to buy Company Y, and begins to purchase their stock with corporate funds, are there any tax ramifications at that point?

Mr. BROCKWAY. The tax ramifications are that when they purchase the stock, the selling shareholder has to recognize gain on the sale of the stock.

Also, the acquiring corporation, will be using some funds. Now, those funds might be borrowed and if so, the taxpayer is generating an interest deduction. Alternatively, the funds, rather than being used to acquire another corporation might have otherwise been paid out as dividends to shareholders. Had the corporation done so, those funds would be fully taxed at ordinary income rates.

And so, yes, there are tax ramifications but not directly.

Mr. SCHULZE. In the normal course, aside from a company's pension funds, is one method of diversification just to have a portfolio of stocks, or is that not done?

Mr. BROCKWAY. That is being done now on an increasing basis, but not so much in buying a diversified portfolio of common stocks, although some institutions like insurance companies might be in that situation.

But one item we didn't get into today is that for corporations, if they own portfolio stock, they are only taxable on 15 percent of the

dividends they receive, and so that a corporate investor would much prefer to own stock than debt.

Now, a currently taxable corporate issuer will have a tax disadvantage from issuing stock rather than debt, because the issuer will lose the tax deduction. But if the issuer, because of excess losses and credits, doesn't have any current tax liabilities and is not likely to have any for some time into the future, it might issue preferred stock, which apparently is being done now in increasing frequency, often with variable dividend rates, that are adjusted to reflect prevailing interest rates. Because of the 85-percent dividends received deduction when other corporations invest in these variable rate preferred stocks that are the functional equivalent of debt, they are only taxed on 15 percent of their dividend income rather than the entire amount. So it is happening, in fact.

Mr. SCHULZE. The list of a corporation's stockholders belongs to whom? It belongs to the corporation.

Does anyone else have a right to get that list? What does the law say in that area?

Mr. BROCKWAY. In addition to the Government, generally I believe——

Mr. SCHULZE. If I own 10 percent of the stock——

Mr. BROCKWAY [continuing]. That if a shareholder wished to send out a proxy statement under the security laws, the shareholder would be entitled to the corporate shareholder mailing list, and so that if the shareholder meets the requirements to make a proxy——

Mr. SCHULZE. SEC regulates in this area?

Mr. BROCKWAY. That is correct.

Mr. SCHULZE. SEC regulations pretty much govern then notification and the other ramifications as you go through the merger process?

Mr. BROCKWAY. That is correct. It would not be tax rules.

Mr. SCHULZE. Thank you.

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Schulze.

Again, thank you, Mr. Brockway, and all the members of your staff.

We will now ask Mr. Ronald Pearlman if he will take the witness table.

Mr. Pearlman is the Assistant Secretary of Tax Policy for the Department of Treasury. He has been here since early morning.

We thought, Mr. Pearlman, we would have your testimony long before now. I regret that you have been held up today, but this was the Senators' hour this morning, it looked like, and they were full of sound and some fury, and it has taken longer than we anticipated.

We do appreciate your indulgence and we look forward to your testimony, because what you say has a great deal to do with the overall problem, perhaps more than anybody or any witness we have had today. So we will be pleased to hear from you.

STATEMENT OF RONALD A. PEARLMAN, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. PEARLMAN. Thank you, Mr. Chairman. Senators do take precedence over assistant secretaries.

We have submitted a rather lengthy statement to the subcommittees, and I think it is not productive for me to spend a great deal of time going through it, so what I would like to do is highlight some of the key points that I believe are contained in that statement, and then leave the rest of my time for discussion and questions.

Chairman PICKLE. Mr. Pearlman, as you do that, if you can, as you go from page 1 to 10 or whatever it is, if you could state what page you are on.

Mr. PEARLMAN. I would be happy to.

Let me begin, however, by saying that I not only appreciate, as we always do, being here, but I want to extend my compliments particularly to you, Mr. Chairman, for having these hearings. I think this is obviously an important area. It is one that has not only received extensive public attention, but is an area which I think needs to, on a regular basis, receive ongoing review by the tax-writing committees, and I want to compliment you for this hearing.

We have looked at the subject of the Federal income tax implications and incentives of corporate mergers on several occasions over the past several years, and indeed at Treasury going back well before that.

There was testimony in Ways and Means some years ago on this subject, and I think it was last year, although the years tend to blur now, I testified before the Finance Committee on the subject of tax incentives that might be driving mergers in the oil industry.

In that exercise, as we prepared for that testimony, and again as we did for this testimony, we reached some fairly general conclusions that I don't think will come as a surprise to you or be particularly different from perhaps what you have heard before from me, and those are that we believe that the tax laws probably, probably do not drive merger or acquisition activity.

Mr. FLIPPO. Would the gentleman yield?

Would the Chair permit a question at this point?

Chairman PICKLE. Yes, Mr. Flippo.

Mr. FLIPPO. The same question I have asked all the others: Could you furnish us with the documentation, the evidence, to back up your conclusions?

Mr. PEARLMAN. Mr. Flippo, I heard you ask that question before, and I will be happy to try to furnish you as much documentation as we can, but it is very difficult to, and that is the reason I used the word probably.

Mr. FLIPPO. The joint committee quoted a study in 1951.

Mr. PEARLMAN. Yes.

Mr. FLIPPO. That said that they were the major driving forces.

Mr. PEARLMAN. Yes; the problem, Mr. Flippo—and I understand your question, and perhaps the frustration with someone sitting here saying probably does or probably does not—the problem, of course, is that we know that there are a number of factors that are

going to influence any major corporate decision, any business decision, but certainly any major corporate decision, such as the acquisition or sale of a business, and many of those factors are nontax factors, and we all know what those are—market prices, asset valuation fluctuations, particular conditions in a particular segment of our economy.

On the other hand, I do want to quickly add that clearly it seems to us that tax considerations do influence those decisions, and I think that as we continue the process of evaluating specific acquisitions, that we will find that evidence of continued influence, and that the real challenge, I think, on all of us, as we analyze on behalf of the committee and the members of the committee analyze, are the extent to which the tax laws do influence acquisitions directly or indirectly, and the extent to which, whether they do or not, and obviously we know they do to some extent, the tax laws are influencing the forms and the design of acquisitions transactions, which I think is a very important issue, and one that I think definitely the committee needs to look at.

Well, as I indicated, although we think that tax laws are probably not the primary reason for merger activity, they do play an important role, and that I view this hearing today as one in which we look at the extent to which that role is played and how that role is played.

Mr. Chairman, I am now going to jump to page 8 of my statement, and what I am doing basically is skipping over a description of acquisition techniques, because I think Mr. Brockway took you through those, and I see no reason to be duplicative. I am going to quickly turn to the discussion at Roman numeral II in the middle of page 8.

What I would like to do is simply identify—and I am going to try to do this briefly—some of the current structural aspects of the income tax laws, which may encourage corporate acquisitions and takeovers; and having been here through Mr. Brockway's testimony, I know that he has discussed these with you, but I think they are sufficiently important that I want to reemphasize at least some of the points he has made.

The first, and in my judgment, if not the most important, certainly one of the most important is the existence of a tax system which imposes a corporate and a shareholder level tax. There is no question that in corporate tax planning, incentives are to not distribute taxable dividends, at least to those shareholders who are going to pay a tax on those dividends, that is to nonexempt or to shareholders who do not get the benefit of a preferential rate, such as corporate shareholders, which get the preferential rate of the intercorporate dividend. Thus, the incentive is to accumulate funds within the corporation, and perhaps to use those funds to the extent they exceed working capital needs for acquisitions.

In addition to the penalty, if you will, that our current corporate tax system imposes on the distribution of taxable dividends through both a corporate and a shareholder level tax, there may be the pressure on the part of acquiring corporations to look not only to other sorts of equity or assets, but to corporations which do accumulate funds rather than distribute them in the form of dividends,

which may not be the most economic utilization to which one would put excess earnings, as potential targets for acquisition.

And so the incentive not to distribute taxable dividends may serve in a major way, and indeed, I think does serve in a major way, to increase the incentive for corporate acquisitions, rather than dividend distributions.

To the extent that the double tax on corporate earnings does impede the most economically sensible allocation of earnings, which includes dividends or a good business judgment to invest those earnings in working capital or other assets that are productive in terms of the expansion of the business, then the tax system is in fact distorting decision making, and, as I indicated, may in fact encourage acquisition activity.

Therefore, to the extent that we can in any review of the tax system mitigate or eliminate the problem of double taxation, then we do reduce or eliminate this incentive.

And I think it is one not to just talk about in sort of an academic or passing sense. It is an extremely important factor in our tax laws, and one that I think we have to give increasing, rather than passing, attention to.

No. 2—and I am going to jump again, Mr. Chairman, I am now on page 10—is the distinction between capital gain and ordinary income. Closely related to the disparate treatment of distributions to shareholders where dividends are taxed at ordinary income rates, and either liquidating distributions or certain liquidating distributions or sales of stock by shareholders taxable at what frequently will be a preferential capital gains rate is the incentive to convert retained earnings, which might be distributed in the form of dividends, into capital gains through the sale of the stock of the corporation. And to the extent, therefore, that rate differentials between capital gain and ordinary income create that preference, then one could expect that sales of corporations, to the extent shareholders get the benefit of a capital gain, may be unduly influenced, or to some extent at least influenced by this particular tax treatment.

Third is what the statement calls the under-utilization of capital subsidies, what I would like to restate as the creation of net operating losses and other carryovers, as a result of a corporation's inability to fully utilize capital subsidies.

Let me begin quickly by saying I don't want the term "capital subsidies" to be translated into something evil. It is not intended to be that.

We do have in our tax system a variety of incentives targeted to capital formation. The most significant of those are accelerated cost recovery system and the investment tax credit, but there are a number of others.

In addition to that, we have a variety of other items that could, if a company is not able to use them, currently add to either net operating loss or credit carry-forward.

To the extent that a company doesn't have sufficient income or tax liability to benefit from these so-called capital subsidies, then there is an incentive for mergers or acquisitions.

There are limitations, as I am sure you are aware, on the use of tax attributes of an acquired corporation, but these limitations

don't apply in certain forms of mergers, and even where they do, the acquiring corporation may nevertheless benefit to some extent from the acquisition of a target corporation's tax attributes.

Jumping, Mr. Chairman, to page 11, the middle of the page, the ability to benefit from——

Chairman PICKLE. Before you go on to 11, I want to be sure I understand you on your under-utilization. When you use capital subsidies, you are talking about credits and ACRS. And you are saying that the present structures of these credits and ACRS probably lead to a lot of these mergers and acquisitions.

Is that what you are saying?

Mr. PEARLMAN. Let me tone that down a little bit, and say that I am not sure that I can factually, accurately make that statement.

I think all I can say and reasonably say is that to the extent that any current tax incentive can't be utilized by a taxpayer because there is insufficient economic income or insufficient tax liability to consume those tax incentives, then there would be an incentive to combine with a corporation that could use them.

We know that there are some industries in the country that are capital intensive, and that to the extent that they acquire capital assets and are eligible for one or more of the capital subsidies that are currently in our Internal Revenue Code and may not be able to use them because they are in an industry which has gone through a difficult economic period, and don't have sufficient taxable income to use those benefits.

And in that case, then clearly that company, that unused tax attribute becomes an asset, if you will, and it may be to that company's benefit, and some acquiring corporation's benefit, to try to combine in order to use those.

What I don't want to leave the impression with by my comment is that the ability to use the benefit from net operating loss carryforwards, for example, or credit carry-forwards following the acquisition of one company by another, is something that is either bad or inconsistent with sound tax policy, because I don't think it is.

Carryover of a net operating loss or other tax attribute following an acquisition may properly allow a corporation, which made an investment decision that is encouraged by our tax system, to effectively benefit from the subsidy that the Congress and the President chose to include in our tax laws.

Nevertheless, the tax rules governing the carryover of attributes should not encourage corporate acquisitions that would not have been undertaken for purely economic reasons, and those rules should not result in tax attributes becoming more valuable in the hands of the acquiring corporation than they would have been in the hands of a target corporation.

Mr. SCHULZE. If I could interrupt you right there.

Mr. PEARLMAN. Sure.

Mr. SCHULZE. Yet I can see when there would be times when it would be in our Nation's interest. I am thinking now of the steel industry, which has some large NOL's, ITC's and other credits, and in some instances that makes them attractive to be picked up by somebody. In this instance, it is probably in our Nation's interest that they continue in business and it gives them an infusion of capital.

I guess one can say that it can cut both ways, depending upon the circumstances.

Mr. PEARLMAN. Yes. And, Mr. Schultz, that is exactly the point that I was just trying to make. We have a capital cost recovery system that was specifically designed to try to encourage industry in this country to become more competitive, to invest in capital, and certain industries like the steel industry did that, is doing that, and may not be able to fully utilize those tax benefits.

I would not want my comments, and that is what I intended by my statement, to mean that it is not bad if in the marketplace if a member of the steel industry decides that it is in the interest of its shareholders and that of continuing business to combine with another business to make those tax benefits utilized.

In fact, if that were not the case, it might adversely affect that particular business's original decision to invest in capital. So I don't want to leave that impression, and I hope I have not.

What I would like to do, and I think perhaps the most significant thing I could do in this regard, however, is sort of set the stage a bit about why this becomes a problem, and you will find this in the discussion at the bottom of page 11 and on the top of page 12.

The real issue here is the accurate, I would submit, measure of a corporation's taxable income, so that I think I can make the statement that if we knew we were accurately measuring the corporation's taxable income, we wouldn't be as concerned about what some would view as the undesirable carryover of attributes from one corporation to another.

Under current law, a corporation that earns a significant profit may nevertheless have substantial net operating losses and other unused attributes, for the reason that you mentioned, Mr. Schulze, that we have decided to give them in order to encourage certain economic activity.

Our law, however, does not provide for direct reimbursement of net operating losses or the refundability of credits by the Federal Government. That is traditional philosophy in our tax system.

It does not permit corporations with unused tax attributes to transfer those attributes freely to other corporations that can benefit from them. There have always been for long periods of time restrictions on unfettered ability to transfer attributes.

It is that factual setting, the fact that we do not write checks to companies simply because they make certain investments, or they have to have taxable income with which to offset net operating losses or credits, and because we do not permit losses or credits to be freely transferred, that we create an environment that could assure us of the volume of acquisitions as a result of the use, the inability to use within a single corporation those tax attributes.

The adoption of a system that correctly measures economic income would eliminate or certainly substantially reduce the possibility that profitable corporations would have unused net operating losses or excess credits, and the proper measure of corporate income would also greatly diminish the volume of unused favorable tax attributes.

I think what we really want to address here is the influence on acquisitions. And I would suggest to you again that that issue should have a life separate and apart from mergers and acquisi-

tions, that is the correct measure of a business's economic income does influence the extent to which a corporation has net operating losses and unused credits, and that will have some effect on merger and acquisition activity.

And to the extent we address that fundamental issue of the accurate measure of economic income, and thereby diminish the volume of unused favorable tax attributes, I believe there will correspondingly be a reduction in the importance of those attributes in decisions regarding corporate acquisitions or mergers.

Jumping to page 13, I just make the statement that I know has been made previously, and that is that one of the defects that clearly, and I am quite prepared to identify it as a defect, that clearly exists in current law, that does serve as an incentive to acquisition activity, as well as other business activity, is the absence of full and comprehensive recapture rules.

My statement on page 13 refers to the so-called general utilities doctrine. I don't intend to discuss it orally, but permit me to say simply that to the extent that we have a tax system which permits corporate transactions to occur without full recognition of gain on the transfer of assets at the corporate level, then it becomes very significant to look at the nature of the assets that are being transferred. And to the extent that some of those assets are ones which produced prior tax benefits to the corporate transferor, then I believe that the absence of comprehensive recapture rules does serve to encourage the kind of transaction which might otherwise have not occurred.

Mr. PEARLMAN. Now, there are a variety of incomplete recapture rules. We mention the inventory rules as possibly being one.

Clearly in the real estate area, we do not have full and complete recapture with respect to improved real property. That certainly, in some instances, is going to have an incentive for transferring those properties.

And in connection with natural resources, there is at least a question as to whether the recapture taxes work fully.

We discuss all of those in the statement, and I am not going to do that now.

I would like to turn the focus now, Mr. Chairman, to several aspects of current acquisition activity that may merit review by the subcommittee as it proceeds in this examination of the tax aspects of mergers and acquisitions, and the discussion of these items begins at page 16 of our written statement.

There are three of these that I am going to mention: leverage buyouts in general and the increasing use of employee stock ownership plans, in particular, overfunded defined benefit plans, and carryover of tax attributes of thrift institutions.

It was our intention in preparing for this hearing to try to be as neutral as we could in reporting to the committee our views on these issues, so I hope you will not take by our written statement or my comments extensive editorialization, because that is not intended.

They are areas which we believe the committees should be looking at, but I don't want to be taken as suggesting specifically legislative activity at this point because I don't think we are prepared for that.

I know you are familiar with leverage buyout. There is no need for me to describe that, but let me emphasize that clearly we know that the disparity in the tax system between the treatment of interest, deductibility of interest expense by a corporation compared to nondeductibility of dividends is an encouragement to corporations to use debt rather than equity financing.

Obviously a reason for that is the double taxation of the dividend. That is not to mean that this difference between the deductibility of interest and taxation of debt is unique to a corporate taxation environment, because it is not, but it influences a variety of corporate behaviors.

It raises general questions, as has been mentioned already in the questioning this morning, regarding debt-to-equity ratios, decisions by businesses regarding the proper use or the appropriate economic use of available funds. It obviously has an influence on the whole subject the extent to which debt is used by business, by corporate enterprise in this country.

But clearly in the context of a discussion involving acquisitions, we know that the ability to do an acquisition by debt is magnified by the fact that interest is deductible and the extent to which we don't take that into consideration in the tax system, it would have some incentive effect on leveraged acquisitions.

Some of you may be familiar with the fact that in the Treasury fundamental reform proposals transmitted to the President in November, we suggested that at a minimum, in looking at the characterization of interest, both the deductibility and includability of interest, that it is appropriate for the tax system to take into account inflation, to recognize that in the payment of interest there is an inflationary component. And we suggested to the President that we consider the possibility of adjusting the interest deduction and the amount of interest taxable to a recipient by that inflationary component. To the extent that we do not do that, to the extent that inflation is not taken into consideration, then where borrowed funds are used to—the interest on which is tax deductible—are used to invest in assets that also increase in value by virtue of inflation, the tax law permits a current deduction for interest expenses, but no realization of the increase in the value of the asset until its sale. In such cases, the interest deduction could be used to offset income that otherwise would be taxed currently.

When you add the use of the installment sale, and my comments are not linked to acquisitions but are relevant—you add the ability to significantly mismatch the gain that is deferred by the seller, which could be gain that was financed through debt acquisition—the purchaser having used debt to acquire stock or assets, which is then reported on the installment method.

Mr. ANTHONY. I wonder if I may have permission to ask the witness a question at this point.

In your tax reform package, you addressed installment sales, especially if the person who was taking that installment debt would then go discount it. In your package, you said that that is an immediate realization and also a taxable event.

Is this part of the rationale that you are talking about now, or were there other considerations earlier?

Mr. PEARLMAN. I think that is a different issue.

We did, as you point out, in the Treasury report to the President indicate that we were concerned with transactions where people sold property on the installment method and then pledged the obligations and in effect realized the income on those obligations. I presume that could happen in an acquisition. My stock might be purchased by a corporation and I could take that installment obligation to a local bank and pledge it, and in effect realize a gain. It is a broader issue, the recognition that if an installment sale operates in a proper way, I would consider that pledge a transaction, at least as a tax policy matter, that is not proper.

But in a proper way, if we continue the tax policy that to the extent that a cash basis taxpayer or accrual taxpayer is eligibile for installment sale treatment, sells stock on the installment basis, does not get cash today, defers his tax until he does receive cash, that the purchaser of an asset financed with an installment sale nevertheless gets to immediately step up the tax basis in that asset, begin depreciating it right away and may have, in addition to that, financed the acquisition of that asset with debt with respect to which the interest is deductible.

And it is the mismatch that is inherent in installment treatment that I am pointing out as a fact of life, that clearly is a factor that will influence whether a corporate acquisition is going to go forward, or what its structure is going to be.

I am not trying to place a value judgment at this point on whether the current system is good or bad, but to point out to you those things which are going to have an impact on merger and acquisition activity, and the combination of debt acquisition and installment sale treatment clearly has to have an incentive in the leveraged acquisition.

Shifting, if I might, to the bottom of page 17, to the targeted type of leveraged acquisition that we now know as including so-called employee stock ownership plans, ESOP's.

From the beginning of the ESOP, there were incentives given to the ESOP that have made it attractive in leverage buyouts, the reason being that corporations were able to make contributions to the ESOP which then could mire the purchase of corporate stock on a tax-deductible basis.

I think the significant issue now is the extent to which the additional incentives that have been provided for ESOP's over the years, and I would include most significantly those in 1984 increase. And I think the only thing we can say at this point is it is an issue that we all need to look at because these are new provisions, and it is not clear whether those provisions will increase the likelihood that leveraged ESOP's will become a major influence on merger and acquisition activity.

We know the Phillip's transaction has been mentioned, and we know there are others which have occurred fairly recently involving leveraged ESOP's. It is understandable that those transactions would have occurred, particularly because of the 1984 act amendments.

There are very attractive provisions now in the law that would encourage the use of an ESOP in an acquisition transaction.

Now, I don't think that that in and of itself should be viewed by us as sinister. Indeed, the philosophy of the ESOP is to encourage

employee ownership of corporate equity and to the extent ESOP's encourage that ownership, one can say that it is doing exactly what the ESOP provisions were intended to do.

I think we do need to look at, however, the extent to which that policy objective may unduly produce other behavior which has other policy implications that might be viewed as troublesome, and it is in that context that I mention leveraged ESOP's.

Whether after examining the extent to which ESOP's do become a common vehicle in corporate acquisitions, my prediction is they will become increasingly significant in major corporate mergers and acquisitions—although I must say at this point, it is too early to document that—it is purely a speculation—then I think it will be important for all of us to look at whether we are achieving in the best possible way the broader employee ownership of corporations without indirectly subsidizing transactions through the tax system, which otherwise would not have taken place.

Page 20, overfunded defined benefit plans: Any time we talk about merger and acquisition activity, any time over the last several years, one of the subjects that comes up is the extent to which corporate employers are able to take advantage of funds contained in overfunding defined benefit plans either by taking those funds out of the pension plan as a source of cash to make an acquisition of a target corporation or to be used by target corporations for defensive activities to fend off acquisitions.

Now, we have spent a great deal of time together with others in the administration, that is the Department of Labor, the Pension Benefit Guarantee Corporation, and I don't want to ignore mentioning the IRS in this regard, addressing the subject of overfunded defined benefit plans. Our principal focus has been not on trying to influence merger and acquisitions one way or the other, but rather to make sure that to the extent that funds are withdrawn from defined benefit plans, that we do not endanger the retirements and the retirement security of employees for whom those plans were designed.

In May 1983—I am on page 23—Treasury, the Service, the Department of Labor, and PBGC issued some enforcement guidelines dealing with certain transactions involving excess funds, where we saw trends of excess funds being withdrawn from defined benefit plans, and those guidelines are used by the enforcement agencies as standards for approving transactions in which funds are sought to be withdrawn. They are intended to guarantee that the employee's rights in those plans are protected and are adequately funded on a long-term basis. Now, we think that within the confines of existing administrative authority, the guidelines do protect the interests of participants in plans that are involved in these various withdrawal transactions.

Similarly, it is our view that the recent involvement of overfunded plans and acquisitions and acquisition-related transactions does not warrant specific legislation to limit the rights of plan sponsors to terminate their defined benefit plans.

We are concerned that if the Congress were to so legislate, that we may indeed discourage employers from establishing, maintaining or properly funding defined benefit plans—and we do not think that would be in the interest of businesses who desire a plan for

retirement of their employees—so I think we must be careful not to undermine the voluntary nature of the pension system.

However, in examining merger and acquisition activity, it certainly is proper, we believe, to consider action to reduce the general incentive for plan sponsors to terminate plans and extract assets for nonretirement purposes.

The last item I want to mention to you, Mr. Chairman, which begins on page 24, is a fairly narrow one and has to do with legislation that came in in 1981 relating to the carryover of tax attributes of thrift institutions.

In 1981, Congress amended the reorganization rules of the code that relate to the bankruptcy reorganization provisions in order to permit the bankruptcy, the insolvency reorganization of savings and loans, savings banks, so-called thrift institutions.

This was done at the suggestion of the Federal Home Loan Bank Board, and it was designed to resolve an issue, an administrative issue, a tax issue of whether the continuity of interest requirement, which is a tax concept, applies to reorganizations involving thrifts.

The Internal Revenue Service had taken the position prior to ERTA that the merger of a stock thrift association into a mutual association could not qualify as a tax-free reorganization.

And as a result of that, coupled with the uncertainty of the application of the continuity of interest requirement in so-called G reorganizations, insolvency reorganizations to thrifts, the Congress determined that it was desirable to try to resolve that issue. And it did so in 1981 by lifting the continuity of interest requirement in G reorganizations involving a transfer to a thrift institution if certain requirements are met.

In these acquisitions, a profitable financial institution typically would agree to assume the transfer of a thrift's obligations in consideration for payments from a regulatory body, such as FSLIC, and the right to succeed to the transferor's tax attributes.

The tax attributes which the acquiring corporation seeks to preserve are the accumulated net operating losses and other carry forwards and the transfer of the thrift's basis in its assets. Typically we are talking about residential mortgages, with basis in excess of their fair market value.

Under these revised rules, neither the shareholders nor the creditors, that is, the depositors of the troubled thrift, receive a continuing ownership interest in the acquiring corporation. To permit tax attributes to carry over in these transactions does depart, and I think Congress recognized that in 1981, from traditional principles underlying the tax-free reorganization and provides a tax subsidy for private acquisitions of thrift institutions.

In effect, the subsidy may operate to shift some or all of the burden of the thrift losses from FSLIC, the private insurance agency funded by the industry, to the Federal Government through the tax system.

Congress thus should consider carefully whether subsidies to the thrift industry are necessary and whether they should be made through direct approprations or through the tax laws, recognizing that the latter route might be less efficient and more costly in the long run.

In a merger and acquisition analysis, we believe that it is appropriate to address that issue. In doing so, however, we recognize, as I am sure members of the committee will, that the thrift industry is undergoing a period of restructuring and that there may, as with so many of the issues that come before the tax committee, be nontax considerations for encouraging the flow of capital into the thrift industry.

If the thrift reorganization rules are retained, we suggest that the subcommittees examine whether the special thrift reorganization rules should be limited to acquisitions of a thrift by a bank or another thrift. These provisions were enacted to facilitate the rehabilitation of a thrift through its acquisition by another thrift under the supervisory powers of a certifying agency.

Although the statutory language and the legislative history do not explicitly suggest that these provisions are limited to acquisitions of troubled thrifts by other depository institutions, strong concerns existed in 1981 that these special rules not be used to permit the ready transfer of realized and built-in losses of a troubled thrift to a corporation, other than a depository institution.

Indeed, the Bank Board, in seeking this legislation, assured the staffs of the tax-writing committees and the Treasury Department that the principal purpose of the legislation was to remove the technical obstacles to supervised mergers involving troubled thrift institutions.

Though these acquisitions may technically satisfy the statutory requirements of the code, the potential transfer of tax losses of troubled thrift institutions to corporations other than banks or other thrifts clearly go beyond the intended scope of the 1981 legislation.

To date, the Service has not issued rulings involving troubled thrifts where the principal trade or business of the acquiring corporation is unrelated to banking.

Thus, if the thrift institution reorganization provisions are to be continued, we suggest that you clarify the scope of these provisions. And indeed, if you intend these provisions to extend to non-financial institutions, it probably would be well to so indicate in the statute.

Not to get into specifics, but simply to indicate that we are mindful of the spirit of legislative proposals that are currently being discussed to deal with certain merger and acquisition activity. Many of those have been the subject of discussion this morning.

It is our view, Mr. Chairman, that whether the concern is with the hostile takeover, whether the concern is with greenmail, that these are issues that certainly could have significant implications to our economy and to the country, but we do not think that in general the tax system should be used to deal with nontax issues.

With respect to hostile takeovers, it would be, I think, unfortunate and extremely difficult to try to establish a set of rules that treated hostile takeovers different than friendly takeovers, if we could even do it.

With respect to greenmail profits, while we would not object to a statutory confirmation of what we believe to be the current law, that greenmail payments are not deductible, we do not think that

there is a need for special tax provisions to curtail greenmail payments.

What I have tried to do, Mr. Chairman, in my comments is to indicate that we do not think—although, Mr. Flippo, I can't confirm that I am right at least at this point—we do not think that the tax rules currently in the statute are driving the recent surge of corporate acquisitions and takeovers.

We certainly recognize that they are a factor to be considered in any corporate acquisition and they may be the proper subject of legislative reform.

I would mention in conclusion just one item that I do feel very strongly about from a legislative standpoint, and I understand you do too, Mr. Chairman, and that is the importance in the merger and acquisition area of net operating loss carryover rules of sections 382 and 383 of the code, the fact that the effective date of rules that were enacted some years ago keeps getting put off every year, and the importance which I hope Treasury shares with members of the Ways and Means Committee to try to deal with those rules, because they do need legislative attention as quickly as we really can.

I would urge the subcommittee to undertake a review of those rules this year. I think it is an issue that we can deal with in 1985.

We feel very strongly that we do need to get those rules in shape so everyone, the taxpayers and tax advisers and the Internal Revenue Service alike, know what they are.

We look forward to working with you and other members of the Ways and Means Committee this year to try to get that piece of unfinished business behind us.

I think I am going to stop at this point.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF RONALD A. PEARLMAN, ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. Chairmen and Members of the Subcommittees, I am pleased to appear before you today to discuss some of the more significant Federal income tax aspects of corporate acquisitions. The recent surge in merger activity and the publicity surrounding recent acquisitions (and attempted takeovers) of large, publicly held corporations has renewed concern that our tax laws inappropriately encourage these transactions. We do not know all of the economic and other reasons behind the recent flurry of activity. However, we doubt that tax considerations are the driving force. We suspect that other market forces precipitate these transactions, forces that reallocate resources to higher valued uses, promote economies of scale, increase shareholders' return on investment, replace inefficient management, and free up capital for new investment opportunities. Only those persons responsible for the merger activity know for certain the forces that drive their decisions; I will not today speculate on their decision making process, instead I will concentrate on the principal tax aspects of mergers and acquisitions and defer to the expertise of others on the effect of these corporate acquisitions on the economy as a whole.

While it is doubtful that our tax laws are primarily responsible for the recent merger upswing, they play an important role in these transactions, just as they do in virtually every business transaction corporations conduct. The subject of the hearing today concerns those aspects of our current tax laws that exert the greatest influence on merger activity. The first part of my testimony summarizes the different types of corporate acquisitions and describes the divergent tax consequences that may be obtained. The second part of my testimony discusses certain structural features of our tax system that appear to encourage corporate acquisitions and takeovers. The third part of my testimony describes recent trends in merger activity that raise significant tax policy issues. Included among these are the use of ESOPs

in leveraged buyouts, the use of asset reversions from overfunded defined benefit plans to finance mergers and acquisitions and the carryover of tax attributes in mergers and acquisitions of thrift institutions. Finally, I will discuss certain legislative proposals that are inspired by the current wave of mergers and acquisitions.

I. Taxing Corporate Acquisitions—An Overview

In general, for tax purposes, corporate acquisitions are categorized into two basic forms—taxable and tax-free. While this categorization vastly oversimplifies how the tax law applies to these transactions, it is useful in analyzing the important tax policy questions in this area to think of the transactions as coming within one of these two categories; for it is this categorization that will trigger the most significant tax consequences. This first part of my testimony summarizes the types of mergers and acquisitions that come within each category and their principal tax consequences.

A. TAX-FREE ACQUISITIONS

The distinctive characteristic of a wholly tax-free acquisition is that no gain or loss is recognized by the target corporation or its shareholders. The target shareholders are permitted to roll over their investment position in the target corporation for an investment position in the acquiring corporation without paying current tax. This tax-free rollover, however, is generally available only to the extent the target shareholders receive stock of the acquiring corporation or certain related corporations. Other consideration received by the target shareholders is taxable either as dividend income or capital gain, depending upon the application of a complicated set of judicial and statutory rules that strive to make this ever difficult distinction.

A tax-free acquisition generally will not generate taxable income to the target corporation, even if that corporation has appreciated assets. The corollary of this tax-free treatment is that the target corporation's historic tax basis for its assets "carry over" to the acquiring corporation and are not "stepped-up" (or down) to fair market value. Moreover, with certain limitations discussed below, tax attributes of the target corporation, such as net operating losses and unused credits and accumulated earnings and profits, will also carry over to the acquiring corporation.

To qualify as a tax-free acquisition, the transaction generally must qualify as a "reorganization" as defined in section 368 of the Code.[1] Although the statutory definition and judicial interpretations place significant constraints on how a reorganization can be structured, significant flexibility does exist. Thus, a tax-free acquisition can take the form of a direct acquisition of the target corporation's assets, the acquisition of the target corporation's stock, or a combination of the target and the acquiring corporation pursuant to statutory merger or consolidation.

B. TAXABLE ACQUISITIONS

The principal characteristic of a taxable acquisition that sets it apart from a tax-free acquisition is that the seller in a taxable acquisition cannot receive a tax-free rollover of his investment. The seller in a taxable acquisition can be either the target corporation (a taxable asset acquisition) or the target shareholders (a taxable stock acquisition). The collateral consequences of a taxable asset acquisition and a taxable stock acquisition differ in so many respects that each will be discussed separately.

1. Taxable asset acquisitions

In a taxable asset acquisition, gain or loss is recognized by the target corporation, unless, as discussed below, the target corporation is completely liquidated within a statutorily prescribed time. The sale may be reported on the installment method, however, in which case any capital gain is deferred and reported as the installment payments are received. In any case, the tax basis of the assets acquired are adjusted

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[1] A "reorganization" is defined in section 368(a) as including four basic types of acquisitions: statutory mergers (type "A" reorganizations), stock-for-stock exchanges (type "B" reorganizations), asset-for-stock exchanges (type "C" reorganizations), and bankruptcy reorganizations (type "G" reorganizations). Tax-free acquisitions can also be effected through compliance with section 351. In addition to satisfying the statutory definition, a reorganization must meet certain other regulatory and common law tests (such as the "continuity of interest" and "continuity of business enterprise" tests) in order to qualify as a reorganization. Although there is some uncertainty regarding application of these statutory and judicial tests to particular fact patterns, there is a substantial body of case law and Internal Revenue Service rulings and past history that provide guidance to taxpayers.

to reflect the purchase price paid for those assets. In a taxable asset acquisition, the acquiring corporation does not succeed to any of the target corporation's tax attributes, such as net operating losses and unused credits and accumulated earnings and profits. These tax attributes, however, will be available to offset the target corporation's income and tax liability resulting from the sale.

If a transaction is a taxable asset acquisition from a corporation that has adopted a plan for complete liquidation within a 12-month period, generally no gain or loss is recognized by the selling corporation (except to the extent of recapture and other tax benefit items). Gain or loss is recognized, however, by the shareholders of the liquidating corporation based upon the difference between the amount of the liquidation proceeds received and their stock basis. If the target corporation sells its assets for installment notes that are distributed in liquidation, the target shareholders can report their gain on the installment basis to the extent they receive the notes.

2. Taxable stock acquisitions

In General. If a transaction is a taxable stock acquisition, gain or loss generally will be recognized by the selling shareholders, but may be reported on the installment method if installment notes are received. The tax consequences to the target corporation and the acquiring corporation depend upon whether the acquiring corporation makes a section 338 election.

The immediate effect of a taxable stock acquisition is that the target corporation becomes a subsidiary of the purchasing corporation. If no section 338 election is made for the target corporation, no gain or loss is recognized with respect to target's assets and its corporate tax attributes are preserved, subject to certain limitations discussed below. If a section 338 election is made, the taxable stock acquisition takes on most of the characteristics of a taxable asset acquisition from a liquidating target corporation.

Section 338 Elections. A section 338 election is available where one corporation purchases at least 80 percent of the stock of a target corporation over a 12-month period. In such case, the purchasing corporation may elect to adjust the basis of the assets of the target corporation as though the target corporation sold all of its assets to a new corporation in connection with a plan for complete liquidation within a 12-month period. The price at which the assets are deemed sold by the target corporation and purchasd by the new corporation is generally the purchasing corporation's basis in the target's stock at the acquisition date.[2] A section 338 election requires that the target corporation generally recognize its recapture and other tax benefit items as if it had sold its assets pursuant to a plan of complete liquidation.

Section 338 also contains consistency rules designed to prevent a purchasing corporation from obtaining a step-up in basis for some of the target's assets, while preserving target's corporate tax attributes and historic tax basis for other assets. The typical case addressed by these rules is one where target has one group of high value, low basis assets with respect to which the purchaser wants to take depreciation, amortization, and depletion deductions on a stepped-up basis, and another group of assets which may carry either a significant recapture or other tax liability or valuable tax attributes (such as net operating loss or credit carryforwards). If the purchasing corporation were to acquire all of target's assets, all assets would receive a stepped-up basis, target (assuming target liquidated within a 12-month period) would be taxed only on the recapture and tax benefit items on all assets, and the corporate tax attributes of target would be extinguished. From a tax planning perspective, the purchasing corporation would like to step-up the basis of the first group of assets (for instance, by a direct asset purchase), yet avoid the recapture tax and maintain a carryover of basis for the second group of assets and the valuable corporate tax attributes of target (by acquiring all of the target stock and not making a section 338 election).

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[2] Section 338(a)(1) provides that the target corporation is deemed to sell its assets at their fair market value on the acquisition date. Alternatively, in the case of a bargain stock purchase, an election may be made under section 338(h)(11) to determine the aggregate deemed sale price on the basis of a formula that takes into account the price paid for the target corporation's stock during the acquisition period (grossed-up to 100 percent) plus liabilities (including taxes on recapture and other tax benefit items generated in the deemed sale) and other relevant items. Section 338(b) provides that the new corporation is deemed to purchase the target corporation's assets at an aggregate price equal to the grossed-up basis of recently purchased stock plus the basis of nonrecently purchased stock (subject to an election under section 338(b)(3) to step-up the basis of such nonrecently purchased stock) plus liabilities (including taxes on recapture and other tax benefit items generated on the deemed sale) and other relevant items.

To prevent this type of tax motivated tailoring acquisitions, the consistency rules require that the purchasing corporation must elect either to step-up the basis of all acquired assets (with the associated recapture and loss of corporate tax attributes) or to carry over the basis of all acquired assets (generally with the continuation of tax attributes). Section 338 generally provides that a step-up in basis (and attendant recapture and other tax consequences) will be triggered automatically if, within the period beginning one year before the beginning of the acquisition and ending one year after control is acquired, any member of the purchasing group acquires the stock of any corporation affiliated with the target corporation (target group) or an asset from any member of the target group, other than in certain defined transactions.[3]

C. CARRYOVER OF CORPORATE TAX ATTRIBUTES

1. In General

Under current law, a corporation that incurs a net operating loss in one year generally is permitted to carry back the loss to offset income earned in the three taxable years preceding the year in which the loss is incurred and to carry forward any excess to offset income earned in the 15 years after the loss is incurred. A net capital loss generally may be carried back to the three taxable years preceding the loss and then carried forward to the five taxable years succeeding the loss. The underlying premise of allowing a corporation to deduct a net operating loss or a net capital loss incurred in one year against taxable income earned in another year is to ameliorate the unduly harsh consequences of an annual accounting system. In other words, the ability to carry losses back and forward is intended as an averaging device. For similar reasons, corporations that are unable to use all their credits against tax in the year in which the credits are earned may use such excess credits to offset tax liability in the three prior taxable years and the 15 succeeding taxable years.

The ability to carry over net operating losses, unused credits, and other tax attributes following certain corporate acquisitions, as described briefly above, may affect such acquisitions in a variety of ways. The ability to carry over corporate tax attributes, for example, may affect both the form of acquisitive transactions and the price paid or the value of other consideration used in such transactions. Moreover, the ability to carry over tax attributes may in certain instances influence whether an acquisition will be undertaken. The ability to carry over tax attributes after a corporate acquisition, however, is limited under current law in several respects.

As mentioned above, the tax attributes lof a target corporation generally survive a tax-free reorganization and carry over the the acquiring corporation. In addition, if a corporation acquires the stock of another corporation in a taxable transaction, the tax attributes of the target corporation also survive the acquisition, unless a section 338 election is made for the target corporation. Moreover, although a purchasing corporation that does not make a section 338 election will not succeed directly to the tax attributes of the target corporation, it may benefit from the target corporation's net operating losses, net capital losses, unused credits, and other tax attributes, if the target and purchasing corporations join to file a consolidated income tax return. Alternatively, a purchasing corporation that does not make a section 338 election may inherit the tax attributes of the target corporation if the target is liquidated or merged into the purchasing corporation.

2. Limitations on the carry over of tax attributes

Under sections 382 and 383,[4] the ability of an acquiring or purchasing corporation to use or benefit from the net operating losses and other tax attributes of a target

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[3] The excepted transactions included transactions in the ordinary course of business, carryover basis transactions, pre-effective date transactions, and other transactions to the extent provided in regulations. In some cases, the consistency rules can operate to require taxpayers to take a step-up in basis and pay recapture taxes or suffer other tax detriments where no manipulative scheme exists. As contemplated by Congress in the Tax Reform Act of 1984, Treasury is considering allowing taxpayers to elect carryover basis (or cost basis when less than carryover basis in a particular asset) in all assets that a corporation acquires during the consistency period. We do not believe that the providing of this "carryover basis election" would create any significant new tax incentives for corporate acquisitions provided there are appropriate safeguards.

[4] Sections 382 and 383 were substantially amended in the Tax Reform Act of 1976, but the effective date of those amendments has been delayed several times. Most recently, section 61 of the Tax Reform Act of 1984 extended the effective date of the 1976 Act amendments until De-

Continued

corporation following a taxable stock acquisition or a tax-free reorganization may be limited. Sections 382 and 383 were enacted to establish objective tests that would curb "trafficking" in corporations with unused net operating losses and other favorable tax attributes. In the case of net operating loss carryovers, Congress was particularly concerned that profitable, operating corporations were acquiring shell corporations whose principal assets were unused net operating losses that could be applied against income of the acquiring corporations that was unrelated to the business activity of the acquired corporations.

In addition to the specific objective limitations provided by sections 382 and 383, the carry over of net operating losses and other favorable tax attributes may be disallowed under section 269, whenever the principal purpose of an acquisition of stock or assets is to obtain the benefit of losses, deductions, or credits. Thus, section 269 may be applied to deter misuse of the general carry over limitation provisions.

Finally, the ability of an acquiring corporation to benefit from the tax attributes of a target corporation by joining with the target to file a consolidated income tax return is limited by the "separate return limitation year" and "consolidated return change of ownership" rules provided in applicable Treasury regulations. In addition to limiting use of net operating loss and credit carryovers, the consolidated return regulations under certain circumstances also limit the ability to benefit from "built-in" losses following an acquisition.

II. Structural Aspects of the Income Tax That May Encourage Corporate Acquisitions and Takeovers

While we believe economic as opposed to tax considerations typically drive a corporation's decision to acquire another corporation, we recognize that there are a number of structural features of our current income tax system that may encourage corporate acquisitions. The Committees may wish to consider removing or modifying some of the current law provisions that encourage merger activity. As the discussion below will indicate, however, some of the incentives in current law are rooted in the basic structure of how we tax corporations and their shareholders and could not be altered without fundamentally changing the present income tax system.

A. DOUBLE TAXATION OF CORPORATE EARNINGS

Our current income tax system generally treats corporations as taxpaying entities separate from their shareholders. A corporation separately computes and reports its taxable income, and in making this calculation it is not entitled to a deduction for dividends paid to shareholders. Moreover, these dividends are taxed to individual shareholders as ordinary income (except for a $100 per year exclusion). Consequently, corporate taxable income paid as dividends to individual shareholders generally bears two taxes, the corporate income tax and the individual income tax.

The double taxation of corporate earnings that are distributed as dividends to shareholders affects dividend distribution policies in ways that may encourage merger activity. In particular, corporations, especially those with shareholders in relatively high income tax brackets, are encouraged to retain earnings in order to allow the shareholders to defer imposition of the second tax.[5] This pressure to accumulate corporate earnings not only interferes with ordinary market incentives to place funds in the hands of the most efficient users, but also stimulates corporate acquisitions in at least two ways.

First, corporations that accumulate cash funds in excess of their needs for working capital must reinvest those funds; acquiring the stock or assets of other corporations is an investment alternative that must be considered by any corporation with excess funds to invest. Second, a corporation with large amounts of funds invested in nonoperating assets may become an attractive target, because the market may not immediately reflect the value of those nonoperating assets (which may not generate financial reported earnings commensurate with their values). Because of this

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cember 31, 1985. The 1976 Act rules, as well as current law, have been criticized and a number of reform proposals have been made. Although we understand that the Subcommittees are not examining sections 382 and 383 in detail at this hearing, we believe that it is important that Congress address these provisions this year and we look forward to working with the Congress in developing reasonable rules governing the carry over of corporate tax attributes.

[5] Indeed, in some cases the shareholder-level tax can be permanently avoided if the retained earnings are distributed in liquidation following the death of the shareholder, which occasions as tax-free increase in the stock's basis to its fair market value. The double taxation of dividends and the tax-free basis step-up at death operate in tandem to place extreme pressure on closely-held corporations to retain rather than distribute earnings.

potential undervaluation of the target's nonoperating assets, a potential acquiring corporation may view the nonoperating assets as cheap funds available to finance the acquisition of the underlying business operations of the target. The mitigation or elimination of the double tax on corporate dividends, through any form of integration of the corporate and individual income taxes, would reduce or eliminate these effects.

In contrast to the taxation of corporate earnings distributed as dividends, corporate income distributed to creditors as interest is deductible by the corporation and thus taxed only once, to the creditors. The disparate tax treatment of debt and equity in the corporate sector distorts decisions regarding a corporation's capitalization, making corporations more vulnerable to takeover during economic downturns, and also may encourage leveraged buyouts, because interest payments on the debt incurred in such a transaction offset income earned by the target corporation.

Since interest payments on debt financing are deductible and dividends paid on equity are not, corporations are encouraged by the tax law to utilize debt rather than equity to finance their ongoing operations. This may result in an increased debt to equity ratio that increases the risk of bankruptcy and vulnerability to downturns in the business cycle; and any corporation that is temporarily crippled by an economic downturn becomes a likely takeover candidate. The incentive for leveraged buyouts conferred by the more favorable tax treatment of interest payments is discussed further in part III.A.1., below.

B. CAPITAL GAIN—ORDINARY INCOME DISTINCTION

Currently, corporations are subject to tax on ordinary income at a maximum rate of 46 percent and on capital gains at a maximum rate of 28 percent. Individuals are subject to tax on ordinary income at a maximum rate of 50 percent and on capital gains at a maximum rate of 20 percent. While corporate taxable income distributed to individual shareholders as dividends generally bears two ordinary income taxes, the shareholder's receipt of cash or property in exchange for his stock in a purchase of the corporation results in a significant lessening of the double tax burden when compared with the receipt of such cash or property as dividend income. Even though corporate earnings distributed as dividends would be taxed to the shareholders at ordinary income tax rates, the gain attributable to retained earnings is taxed at preferential capital gains rates if the shareholders sell their stock. This capital gains opportunity results in an incentive for the corporations to retain income in corporate solution and for corporate acquisitions.

C. UNDERUTILIZATION OF CAPITAL SUBSIDIES

Capital subsidies (such as certain credits and accelerated depreciation) provided through the tax system may have an unintended ancillary effect of encouraging mergers and acquisitions. In some cases the amount of these tax subsidies have outstripped the recipient corporation's ability to use them effectively by investing in operating assets. To the extent that a corporation cannot effectively reinvest the tax subsidies in operating assets, such amounts are invested in nonoperating assets, which stimulate merger activity as detailed in part II.A., above.

In addition, whenever a company does not have enough income and tax liability to benefit from the accelerated depreciation and tax credit capital subsidies, an incentive for mergers is created. As summarized earlier, there are limitations on the use of tax attributes of an acquired corporation, but these limitations do not apply to certain forms of mergers or acquisitions. And even in cases in which the limitations apply, the acquiring corporation may nevertheless benefit to some extent from the target corporation's tax attributes.

For example, the limitations provided in sections 382 and 383 generally would not apply if a corporation with substantial unused net operating losses and excess credits acquired a profitable target corporation's stock or assets in either a tax-free or taxable acquisition. Accordingly, income and tax liability generated by the target corporation or its assets could be offset in future years by the acquiring corporation's unused tax attributes. Similarly, if an acquiring corporation purchased the stock of a target corporation in a taxable acquisition and did not make a section 338 election, the acquiring corporation could use the target corporation's operating losses to offset future income of the target corporation. If, on the other hand, the acquiring corporation made a section 338 election, although it would not succeed to the target corporation's tax attributes, any income realized by the target corporation by virtue of the section 338 election and the accompanying tax liability could be offset by the target corporation's net operating loss and credit carryforwards.

The ability to benefit from net operating loss and other carryforwards following the acquisition of a corporation is not necessarily inconsistent with sound tax policy. As discussed earlier, a corporation is allowed to carry back and carry forward its unused net operating losses and credits without limitation (other than on the number of carryback and carryforward years). These unused net operating losses and credits may result from capital subsidies to which the corporation is entitled, but is unable to utilize currently. The carry over of net operating losses and other tax attributes following a corporate acquisition may properly allow the target corporation to effectively benefit from the capital subsidies in the same manner as if no acquisition had occurred. Nevertheless, the tax rules governing the carry over of tax attributes should not encourage corporate acquisitions that would not be undertaken on purely economic grounds. Moreover, those rules should not result in tax attributes becoming more valuable in the hands of an acquiring corporation than they would have been in the hands of a target corporation.

In general, we believe that the existing limitations on the carry over of corporate tax attributes do not work well in some respects and improperly allow the carry over of tax attributes in some cases. We do not believe, however, that either the ability to carry over tax attributes in a corporate acquisition or the imperfections in the existing statutory and regulatory limitations on such carryovers is the fuel driving the recent surge of corporate acquisitions. Nevertheless, we do look forward to working with the Congress in reforming those rules this year.

We want to point out, however, that the existence of unused tax attributes and the ability to benefit from such attributes by acquiring control of a corporation would be of much less concern if corporate taxable income were measured correctly and, for example, the existence of unused net operating losses meant that a corporation had realized actual economic losses. Under current law, however, a corporation that earns a significant profit may nevertheless have substantial net operating losses and other unusued tax attributes. Current law does not provide for direct reimbursement of net operating losses or refundability of credits by the Federal government and does not permit corporations with unused tax attributes to transfer those attributes freely to other corporations that can benefit from them. The consequence of such a system is the existence of an increased volume of tax attributes that can not be used by the corporations to which they are made available. The lack of refundability or free transferability and the resulting increase in the volume of unused tax attributes place significant pressure on the rules that are designed to limit the use of net operating losses and excess tax credits following an acquisition and provide an incentive to acquire corporations with such unused tax attributes.

Moreover, the mismeasurement of income for tax purposes and the resulting increased volume of unused tax attributes may favor conglomeration by encouraging corporations that are engaged in business activities that generate "tax losses" and excess tax credits to combine with other corporations that are engaged in activities with fewer tax attributes. The tax laws should not create such a bias between diversified and non-diversified entities.

The adoption of a system that correctly measures economic income would eliminate the possibility that profitable corporations could have unused net operating losses or excess tax credits and would ensure that companies with loss carryforwards had suffered equivalent economic losses. The importance of rules limiting the use of tax attributes following corporate acquisition would thus be decreased. The proper measurement of corporate income also would greatly diminish the volume of unused favorable tax attributes, and correspondingly reduce the importance of tax attributes in decisions regarding corporate acquisitions and conglomeration.

D. GENERAL UTILITIES DOCTRINE

Some have argued that the section 338 rules and the liquidation rules conflict with the general scheme for taxing a corporation and its shareholders and may encourage corporate acquisitions. Generally, as described above, a corporation is subject to tax on the profits derived from its operations and its shareholders are subject to a second level of tax on the distributions of those profits as dividends. In a liquidating sale of assets or sale of stock with a section 338 election, there is a step-up in basis of assets with only a partial corporate level tax; recapture and tax benefit items are taxed, but other potential gains are not. This result stems from the rule attributed to *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), that is now codified in sections 311(a), 336, and 337. Under those provisions, a corporation recognizes no gain (other than recapture and tax benefit items) on distributions, including liquidating distributions, made to its shareholders. These rules may give an additional incentive to a corporation to sell assets in some cases because it increases

the likelihood that the present value of the tax benefits that accompany property ownership (e.g., depreciation and depletion deductions) may exceed the seller's tax detriment incurred on the sale. Thus, the same assets may be more valuable to a buyer then to the current owner.

Congress has reduced this incentive to sell corporate properties by limiting the scope of the *General Utilities* rule. For example, TEFRA made distributions of appreciated property in a partial liquidation taxable to the distributing corporation. In addition, the Tax Reform Act of 1984 (the "1984 Act") imposed the same treatment on dividend distributions of appreciated property. One major aspect of the *General Utilities* doctrine remains, however. Nonrecognition of gain by the selling corporation continues to be the general rule in connection with a complete liquidation and a deemed asset sale in connection with a section 338 election (although recapture and tax benefit items are taxed). While repeal of this last major exception would simplify the tax laws, we do not believe that the failure of the corporate tax regime to impose two levels of tax on liquidation transactions is primarily motivating corporate acquisitions. Further, as we have indicated in prior testimony before the Senate Finance Committee, we believe that in considering the repeal of *General Utilities* in liquidation transactions, relief from double taxation of liquidation proceeds must also be considered.

E. INADEQUATE RECAPTURE TAXES

1. In general

Some have suggested that the imperfections in the current recapture rules may be a factor encouraging corporate mergers and acquisitions. If the *General Utilities* rule were fully repealed and a corporation were required to recognize gain to the extent the amount realized exceeds its basis in assets, the effectiveness of the recapture rules would not be as important. Short of a complete repeal of the *General Utilities* rule in a liquidation context, it may be appropriate to tighten current recapture rules. For example, under current law, a liquidating corporation that used the last-in first-out ("LIFO") method of accounting for inventories is required to recognize income attributable to the difference between the value of inventory determined on the LIFO basis and that determined on a first-in first-out ("FIFO") basis (commonly called LIFO reserve). This rule could be expaned to include all inventory profit (not just the difference between LIFO and FIFO) and all other ordinary income. In addition, the recapture rules on section 1250 property (including residential real estate) could be conformed to the section 1245 recapture rules applicable to personal property to require the liquidating corporation to recapture ordinary income to the extent of the full amount of prior depreciation allowed. These changes would be premised on the notion that the corporation claiming tax benefits should return those benefits at the time of sale (whether by actual sale or in liquidation) if the sale shows that the earlier granted benefits were excessive.[6] Any strengthening of the recapture rules, however, magnifies the potential double taxation of corporate earnings and any change in the recapture rules should be coordinated with proposals to relieve that double tax burden.

2. Mineral property

Under current law, gain on the disposition of mineral property is recaptured as ordinary income under section 1254 to the extent of intangible drilling costs that were deducted after December 31, 1975. There is no recapture, however, with respect to gains from the sale of mineral property for which intangible drilling costs were deducted prior to that date. Consequently, on the sale or exchange of mineral properties, gain attributable to expenses deductible against ordinary income as in-

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[6] It should be noted that recapture and tax benefit items generally are not recognized upon the sale of a subsidiary. However, such a result may be inconsistent with the basic principles of the recapture rules where the selling corporation and its subsidiary joined in filing a consolidated return for all years in which the deductions (or credits) were claimed. The consolidated return regulations provide for an annual basis increase (or decrease) in the parent's stock in the subsidiary based on the annual increase (or decrease) in earnings and profits, rather than taxable income, of the subsidiary for such year. Some have suggested that these rules may permit the selling parent corporation to understate its gain (as well as avoid recapture income) because the basis of the subsidiary's stock is inappropriately increased whenever the earnings and profits increase in an amount greater than taxable income. This disparity between earnings and profits and taxable income typically is due to certain tax subsidies, such as accelerated depreciation. The Internal Revenue Service takes the position that allowing this basis increase would result in impermissible double deductions to the selling affiliated group and is currently litigating this issue.

tangible drilling costs prior to 1976 is taxable at capital gain rates even though the drilling expenses were deducted against ordinary income.

Prior to 1975 integrated oil companies could deduct percentage depletion at a rate of 22 percent with respect to mineral property. Percentage depletion deductions are not limited to the taxpayer's basis in the mineral property; so that, with respect to pre-1975 properties, the adjusted depletable basis (investment costs other than intangible drilling costs) for most taxpayers is zero. Since 1975, however, integrated oil companies have been required to use cost depletion. Thus, in effect, most integrated oil companies receive no depletion allowances if they continue to produce from pre-1975 properties. Upon a disposition of mineral property to another who would be allowed cost depletion for the same property, current law does not require recapture of either cost or percentage depletion allowances; this rule applies whether or not percentage depletion allowances were taken in excess of the taxpayer's basis.

Some have suggested that recapture rules should be applied to intangible drilling costs deducted in respect of mineral properties regardless of when the deductions were taken. We cannot support such a change. The recapture of intangible drilling costs was considered extensively by Congress in connection with legislation in 1976. Congress enacted a recapture provision at that time and settled upon what it considered to be a fair transition rule. We do not believe that it is appropriate to change that transition rule retroactively.

Suggestions also have been put forth to apply recapture rules to percentage and cost depletion allowances. Normally, as in the case of depreciable personal property, recapture of depreciation is provided when the property is sold or exchanged; only the excess of the selling price over original basis is eligible for capital gains rates (and nonrecognition at the corporate level in a liquidating sale). The lack of adequate recapture rules creates an incentive to sell to a buyer who will obtain the benefit of a step-up in basis (and therefore larger deductions against ordinary income) at the cost of only a capital gains tax to the seller. The failure to recapture cost depletion allowances thus may provide some incentive for acquisitions of companies with mineral properties. We do not believe the recapture rules applicable to mineral property should differ from the current recapture rules applicable to personal property. In either case, full recapture is needed to minimize inefficient churning of such property solely for tax reasons.

Although we would support full recapture of cost depletion, we would not support the application of recapture rules to percentage depletion. The percentage depletion allowance is, in effect, a negative excise tax on the production of minerals which results in a lower effective income tax rate for those eligible for its benefits. While it may be appropriate to consider reducing or eliminating future allowances for percentage depletion, we do not believe the special rate of tax on mineral properties that Congress provided by way of the percentage depletion allowance should be retroactively repealed by extending the recapture rules. Congress dealt with the policy considerations involving the availability of this special tax incentive to integrated oil companies by limiting such taxpayers to cost depletion for taxable years ending after December 31, 1984.

III. Recent Developments in Corporate Acquisitions That Raise Significant Tax Policy Issues

The structural aspects of the current income tax law discussed above may encourage merger and acquisition activity to some degree, but as stated at the outset, we do not believe they are the driving force behind the current flurry of activity. A number of the publicized acquisitions that are of interest to the Committees involve tax techniques that have only recently evolved, and to some extent these techniques are based upon recently enacted tax incentives. We are concerned that these tax incentives are being employed in mergers and acquisitions in ways that Congress did not intend. Principal among our concerns are the use of ESOPs in leveraged buyouts and the carryover of tax attributes in mergers and acquisitions of thrift institutions. I would also like to comment upon the growing use of asset reversions from overfunded defined benefit plans to finance mergers and acquisitions.

A. LEVERAGED BUYOUTS AND THE GROWING USE OF ESOP'S

1. Leveraged buyouts

The prototypical leveraged buyout involves the conversion of a publicly held company into a private company pursuant to an acquisition by a newly organized private company of all of the target company's stock. The acquiring company usually is organized and controlled by the senior management of the target company. The pri-

vate company's acquisition of the target stock is largely debt financed, with the expectation that the debt will be retired out of future earnings of the company.

As is the case with other mergers and acquisitions, we expect that leveraged buyouts are motivated primarily by economic factors. Nevertheless, the income tax law to some extent may encourage leveraged buyouts of corporation by the more favorable tax treatment of interest payments. As discussed earlier in part II.A., the deductibility of interest payments by a corporation compared to the nondeductibility of dividends encourages corporations to use debt rather than equity in financing operations or acquisitions because of the potential for double taxation of corporate earnings distributed as dividends.

The deductibility of interest incurred in connection with debt-financed acquisitions also encourages these acquisitions to the extent that our tax system does not take account of inflation properly. Nominal interest rates typically include an inflation component which compensates the lender for the anticipated future reduction in the real value of a fixed dollar amount debt obligation and acts as an offsetting charge to the borrower for the inflationary reduction in the value of the principal amount of the borrowing. Where borrowed funds are invested in assets that also increase in value by virtue of inflation, the tax law permits a current deduction for interest expenses but no realization of the increase in value of the asset until its sale or disposition. In such cases the interest deduction can be used to offset income that otherwise would be taxed currently.

The use of installment debt in acquisitions leads to significant mismatching of the gain that is deferred by the seller and the allowance to the purchaser of depreciation, amortization, or depletion deductions determined by reference to asset values that have been stepped-up to fair market value as a result of the acquisition. This asymmetrical treatment of a sale, under which the buyer is treated as acquiring full ownership of the asset while the seller is treated as making only partial sales each year over the term of the contract may create a tax bias for installment debt-financed acquisitions. In a taxable corporate acquisition (an asset acquisition or a stock acquistion with a section 338 election), this mismatching is reduced to some extent if the target corporation's assets are subject to recapture tax since the recapture income is recognized immediately. The asymmetrical treatment arising from installment sales debt is a problem that should concern these Committees, but the problem exists in every installment sale of a depreciable asset and is by no means unique to corporate acquisitions.

The tax arbitrage from debt financing generally is available for all debt-financed assets, not just those acquired in a corporate merger or acquisition. The only special limitation on the deductibility of interest on debt incurred in acquisitions is found in section 279 which applies only under very limited circumstances. Although it may be appropriated to give consideration to revising the general rules regarding the deductibility of interest we see no justification for a further limitation on the deductibility of interest expense that is aimed specifically at debt incurred in connection with corporate acquisitions.

2. Leveraged employee stock ownership plans

While every leverage buyout raises the concerns just noted, we have particular concerns about the use of leveraged employee stock ownership plans (ESOPs) to effectuate leveraged buyouts and to defend against attempted takeovers. Since Congress first established special tax incentives for ESOPs, these plans have been used frequently in leveraged buyouts, but the 1984 Act makes ESOPs an even more attractive vehicle for purchasing shares in a leveraged buyout.

In a leveraged ESOP, the ESOP borrows to purchase stock of the company that establishes the ESOP, and the company obligates itself to contribute amounts to the ESOP sufficient to enable it to service the debt. The employer may deduct these contributions to the ESOP currently without regard to the restrictive limits on employer contributions to other types of employee benefit plans. Because the ESOP is a qualified plan, an employee participating in the ESOP is not required to include these contributions in income until he or she receives a distribution from the plan.

Under the terms of a typical leveraged ESOP, employees are not entitled to distributions from the plan until separation from service. When the ESOP distributes stock to a participant, the employee is taxed on the value of the stock (determined with reference to the price paid by the ESOP) and accumulated income which has been allocated to the participant's account. A paticipant has the right to require the employer to purchase the stock from the participant at fair market value, unless the stock is readily marketable and traded on an established securities market.

An ESOP is required to give covered employees the right to vote publicly traded shares held by the ESOP. But employees can vote shares held by the ESOP that are

not publicly traded, only with respect to actions (such as mergers or liquidations) which require an affirmative vote of more than a majority of the corporation's shares.

It is possible that the nominal beneficiaries of the ESOP, the corporation's employees, will obtain little current benefit from the arrangement. This is true because, while the ESOP may own a significant percentage of the outstanding employer securities, a participant employee will not realize the value of the securities originally purchased by the ESOP until separation from service. Finally, because leveraged buyouts involve privately held corporations, the employees generally are entitled to only very limited voting rights with respect to ESOP stock.

Despite the uncertainty of the benefits that an ESOP confers on covered employees, in the 1984 Act Congress expanded the incentives for employee stock ownership through ESOPs in four ways: (1) banks, insurance companies, and other commercial lenders may exclude one-half of the interest paid or accrued on a loan the proceeds of which are used by a leverage ESOP to purchase qualified stock; (2) taxpayers are permitted to defer gain from the sale of stock to an ESOP if the proceeds are used to purchase stock in a second corporation; (3) corporations may deduct dividends paid to employees with respect to stock of the employer held in an ESOP or stock bonus plan; and (4) an ESOP may assume the estate tax liability with respect to stock of a closely held business which is transferred to the ESOP.

Historically, the employer's right to deduct ESOP contributions while the employees participating in the ESOP defer income has been a significant subsidy which has made the use of ESOPs a favored vehicle for leveraged buyouts. The 1984 Act, however, so enhanced the tax benefits available to leverage ESOPs that we believe not only will the use of ESOPs, in leveraged buyouts increased, but the total number of leveraged buyouts may actually increase. In addition, we expect that these new incentives will greatly increase the use of leveraged ESOPs to defend against potential takeovers.

The most significant of the new incentives of the use of ESOPs in leveraged buyouts is section 133 of the Code which permits banks, insurance companies, and other commercial lenders to exclude one-half of the interest paid or accrued on a loan the proceeds of which are used by a leveraged ESOP to purchase qualified stock. This permits lenders to charge a lower interest rate and thus lower the costs of acquiring employer securities through an ESOP. We understand that the subsidy provided under section 133 allows qualifying lenders to provide financing to an ESOP at approximately 80 percent of the otherwise available interest rate. For example, if the rate available to the ESOP would be 10 percent without regard to section 133, the ESOP could save approximately $140,000 in interest charges on a ten-year, level payment, $1,000,000 obligation, assuming an actual interest rate of 8 percent. Such a significant reduction in the cash flow required to finance an acquisition is certain to stimulate leveraged buyouts.

The 1984 Act provisions also created an incentive for owners of businesses, to sell to their ESOPs rather than to others. New section 1042 allows a shareholder to defer the gain on the sale of shares in the corporation to an ESOP if certain requirements are met. Presumably, the availability of deferral for a shareholder selling to an ESOP will result in a lower purchase price for the shares to the ESOP. Although our limited experience with this provision makes it impossible to know to what extent the special tax benefit to the selling shareholder will be reflected in the price to the ESOP, any reduction in the cost of acquiring a corporation through an ESOP will obviously create a further incentive for leveraged buyouts through ESOPs.

The cumulative effect of these subsidies is to create substantial tax incentives for leveraged buyouts through ESOPs. These benefits insure to those in a position to establish and ESOP and through that device to take a public company private. It also appears that ESOPs are frequently employed as a defensive takeover tactic. These tactics may have an unnecessary dampening effect upon otherwise advisable mergers and acquisitions. Although the goal of encouraging employee ownership may be worthwhile, we believe that any examination of mergers and acquisitions should include an examination of the effects on mergers and acquisitions of the indirect subsidies provided through the current tax provisions relating to ESOPs.

C. OVERFUNDED DEFINED BENEFIT PLANS

Concern also has been expressed recently about the involvment of overfunded qualified defined benefit plans in corporate mergers and acquisitions. Under current law, a company may terminate its defined benefit plan and receive any assets that are in excess of the present value of the participants' accrued benefits as of such termination. There are no restrictions on the company's use of such excess assets.

Because overfunded defined benefit plans thus constitute relatively attractive sources of cash, companies with significantly overfunded plans are thereby made more attractive takeover targets. There are several recent examples of acquiring companies terminating target companies' overfunded plans to partially fund the acquisition. Also, it is not surprising that other companies have terminated their own overfunded plant to reduce the readily available pool of assets to which the companies have access and thereby to make themselves less attractice to other companies. These companies generally have used the excess assets to make less liquid investments (such as equipment purchases), to finance "going private" transactions, or to take defensive actions (such as establishing an ESOP to hold company stock) against potential takeover attempts. Finally, some companies have terminated their overfunded plans to use the assets offensively in their own takeover initiatives or to retire debt incurred in completed takeover transactions.

In assessing the role of defined benefit plans in mergers and acquisitions, one should understand the essential features of such plans and why and in what sense they are overfunded. The law grants favorable tax treatment to employer-maintain retirement plans that satisfy various qualification requirements. There are two types of qualified retirement plans: defined contribution plans and defined benefit plans. Under a defined contribution plan, a participant's accrued benefit is equal to the value of the assets allocated to such participant's account and all plan assets are allocated to participants' accounts. Thus, no assets are available for employer recoupment.

Under a defined benefit plan, however, the participant's accrued benefit is determined under a benefit formula, which generally is based on the participant's compensation and years of participation in the plan. The company maintaining the plan (the sponsor) has the responsibility to make sufficient contributions to the plan to maintain a pool of funds sufficient to provide the participants' promised retirement benefits as they come due. Accordingly, unlike a company maintaining a defined contribution plan, the sponsor of a defined benefit plan bears the full risk of investment gains and losses in the plan's assets.

There are numerous reasons why a defined benefit plan may, at any particular time, hold assets in excess of the present value of participants' accrued benefits at such time. The most basic reason is the inherent nature of the sponsor's obligation to fund a defined benefit plan, as reflected in the minimum funding standards of section 412 of the Code. These standards generally require that a sponsor fund the plan on a "going concern," rather than a "termination," basis. This means that sponsors must currently fund not merely accrued benefits, but also some portion of participants' projected benefits at normal retirement age. In projecting future benefits, future salary increases and inflation ordinarily are considered. In addition, in order to avoid an ever-increasing funding obligation as its workforce ages, a sponsor my choose to fund its plan in accordance with a level-funding actuarial funding method that tends to accelerate contributions relative to the rate of benefit accrual. As a consequence of the natural operation of the funding, rules, a defined benefit plan that is not fully funded on a going concern basis may well be overfunded on a termination basis.

The actuarial methods commonly used in determining sponsors' defined benefits funding obligations rely on long-term assumptions regarding such items as investment returns and salary increases. To the extent that plan investments earn more than anticipated or salaries increases less than expected, overfunding will tend to be greater. For example, during recent years, the rates of return on equity investments have exceeded most actuarial assumptions, which themselves tend to be quite conservative, and salary increases have generally been less than expected.

Furthermore, in determining a defined benefit plan's excess assets it is necessary to calculate the present value of participants' accrued benefits. The higher the interest rate assumption used in this calculation, the fewer assets are necessary to provide participants' accrued benefits. During recent years, insurance companies have been pricing both immediate and deferred annuity contracts for terminating defined benefit plans using recent high interest rates. By reducing the current cost of providing for participants' accrued benefits upon plan termination, this has contributed significantly to the excess termination-basis funding of many defined benefit plans.

Finally, within certain limits (section 404 of the Code), a sponsor is permitted to deduct defined benefit plan contributions in excess of the required contribution under the minimum funding standards. This may of course encourage further employer contributions to a plan, particularly in profitable years, and consequently larger overfunding.

The tax law requires a defined benefit plan to be maintained for the exclusive benefit of the participants and their beneficiaries. In addition, it must be impossible

at any time prior to the satisfaction of all liabilities with respect to the sponsor's employees and their beneficiaries under the plan, for any part of the plan's assets to be used for, or diverted to, purposes other than the exclusive benefit of the employees and their beneficiaries. Because it is not possible to satisfy all plan liabilities before plan termination, a sponsor may recoup plan assets only by terminating its plan. And, in this regard, because a sponsor may voluntarily establish a qualified plan and may voluntarily terminate its plan as it desires, this particular restriction rarely poses a practical obstacle.

A significantly overfunded defined benefit plan thus may be seen, both from the sponsor's perspective and from the perspectives of other companies that may be interested in attempting to take over the sponsor, as a relatively accessible and attractive pool of liquid assets. Of course, the desire to recoup excess plan assets is not limited to companies involved in merger and acquisition transactions. Any business need that requires significant financing—e.g., diversification, expansion of capacity, modernization, advertising—may be sufficient motivation. Nevertheless, due to the substantial cash requirements of acquisitions and acquisition-related transactions, it is natural that companies involved in such transactions will look to defined benefit plans as a potential source of ready funds.

While any assets received upon plan termination must be included in income, the sponsor is entitled to offset this inclusion by any available deductions and credits (including interest deductions and loss carryovers). Thus, because the decision to terminate is in the hands of the plan sponsor, it frequently is possible to time the termination so that none or only a small portion of the assets is subject to tax. To the extent a sponsor is able to achieve this result, terminating an overfunded defined benefit plan becomes more attractive.

One of the primary concerns expressed about the terminations of defined benefit plans to recoup plan assets is the security of the participants' benefits. Under current law, there is no requirement that participants continue to accrue benefits after a plan has terminated. It is thus inevitable that where a sponsor terminates a defined benefit plan and does not establish any other plan in its place, participants will not receive the benefit at retirement that they would have received—and may well have expected to receive—if the plan had not been terminated. In a voluntary pension system, there is very little that the government can do to prevent such terminations beyond assuring that all of the participants' benefits as of the termination are adequately provided.

Of greater recent concern, however, have been reversion transactions under which a sponsor receives plan assets while effectively continuing to maintain the defined benefit plan. These transactions generally have taken two forms: (1) the termination of the defined benefit plan and the establishment of a new defined benefit plan, often identical to the terminated plan (reestablishment transaction); and (2) the spinoff of a defined benefit plan into two plans, one for active employees and one for retirees, the allocation of the excess assets to the retirees' plan, the termination of the retirees' plan, and the continuation of the defined benefit plan for the active employees (spinoff transaction).

In May 1983, the ERISA agencies (the Department of Treasury, the Internal Revenue Service, the Department of Labor, and the Pension Benefit Guaranty Corporation) issued enforcement guidelines (the Guidelines) for purposes of processing reestablishment and spinoff transactions. By requiring the full vesting of all benefits and the purchase of annuity contracts from insurance companies guaranteeing participants' accrued benefits, the Guidelines assure that the security of participants' benefits accrued before the transaction is not adversely affected. In addition, the Guidelines attempt to impose substantive parity between reestablishment transactions and spinoff transactions by requiring the continuing plan in the spinoff transaction to satisfy all of the substantive requirements of a formal termination—e.g., full vesting of benefits, formal notice to participants, and third-party annuitization of benefits. Moreover, the Guidelines extend additional security to plan participants in the continuing plans with respect to benefits accrued after the transactions by strengthening the funding requirements under such plans. Finally, the Guidelines prevent a sponsor from undertaking reestablishment and spinoff transactions on a regular basis by specifying that such transactions may not be undertaken more than once every fifteen years.

We believe that, within the confines of existing administrative authority, the Guidelines appropriately protect the interests of participants in plans that are involved in reestablishment or spinoff transactions. We recognize that some believe that additional protections are necessary, but we are comfortable that the Guidelines strike the proper balance between assuring the security of participants' benefits and not encouraging defined benefit plan sponsors to terminate their plans

without establishing a successor plan. We do not believe that legislation with respect to these specific transactions is necessary.

Similarly, it is our view that the recent involvement of overfunded defined benefit plans in acquisitions and acquisition-related transactions does not warrant specific legislation to limit the rights of plan sponsors to terminate their defined benefit plans as they desire. We are concerned that any such legislative action to curb the termination of plans may unnecessarily discourage employers from maintaining or properly funding defined benefit plans. We must be careful not to undermine the voluntary nature of the pension system in an attempt to dampen related merger and acquisition activity.

We recognize, however, that, in the context of a broader examination of pension and tax policy, it is appropriate to consider action to reduce the general incentive for plan sponsors to terminate plans and extract assets for nonretirement purposes. The impetus for any such action should not, however, be the involvement of overfunded plans in acquisitions transactions—although this certainly would a factor to be considered—but rather should be based only on a full consideration of the applicable pension and tax policies. Thus, any proposal to reduce the incentive to terminate defined benefit plans should apply on an across-the-board basis, without regard to either the reason the sponsor is terminating the plan or the intent of the sponsor to establish a successor plan. For example, after further deliberations, it may be appropriate on pension and tax policy grounds to apply a special excise or minimum tax to asset reversions. This or similar action would reduce the attractiveness of terminating overfunded defined benefit plans in all circumstances.

D. SPECIAL PROBLEMS WITH RESPECT TO CARRYOVER OF TAX ATTRIBUTES OF THRIFT INSTITUTIONS

In the Economic Recovery Tax Act of 1981 ("ERTA"), Congress amended Section 368 of the Code to provide rules relating to bankruptcy reorganizations of thrift institutions (*i.e.*, savings and loan associations and savings banks). These changes, proposed by the Federal Home Loan Bank Board (the "Bank Board"), were designed to resolve the issue of how the continuity of interest requirement applies in reorganizations involving thrift institutions.

Prior to ERTA, the Internal Revenue Service took the position that a merger of a stock association into a mutual association could not qualify as a tax-free reorganization. The Service reasoned that the exchange of the shareholders' stock for deposits in the mutual fails to satisfy the continuity of interest requirement because the deposits are cash equivalents. The courts generally rejected the Service's position, but without the concurrence of the Internal Revenue Service, combinations of stocks and mutuals could not be assured tax-free status.[7]

There was also uncertainty as to the application of the continuity of interest requirement in reorganizations involving thrifts under section 368(a)(1)(G) ("G reorganizations"). In many reorganizations involving thrifts, the transferor's solvency was in question and the Internal Revenue Service took the position that the transaction could qualify as a tax-free acquisition only if it satisfied the G reorganization requirements. However, it was not clear how the continuity of interest requirement applied in a G reorganization involving thrifts. In the case of a mutual association there are no stockholders and the principal creditors are depositors whose interests generally are insured and who are not likely to exchange those claims for stock. Further, stock associations were unwilling to issue stock to those depositors. Consequently, it appeared that the continuity of interest requirement generally barred the reorganization of a thrift from qualifying as a tax-free G reorganization.

To resolve these issues, Congress lifted the continuity of interest requirement in G reorganizations involving a transferor thrift if certain requirements are met. Generally, under these rules, a transaction otherwise qualifying as a G reorganization, in which the transferor is a financial institution to which section 593 applies, will not be disqualified merely because no stock or securities of the transferee are issued, provided: (i) the transferee acquires substantially all of the assets of the thrift and the thrift distributes any remaining assets pursuant to the plan; (ii) substantially all of the liabilities of the thrift (including deposits) become liabilities of the transferee; and (iii) the appropriate agency certifies that, under 12 U.S.C. §1464(d)(6)(A) (i), (ii)

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[7] The Supreme Court recently sustained the Service's position in *Paulsen v. Commissioner*, —— U.S. ——, 105 S. Ct. 627 (1985), ruling that the merger of a stock into a mutual does not satisfy the continuity of interest requirement. In this case, which arose prior to ERTA, the Court held that the interests of the former shareholders of the stock association in the mutual were essentially cash equivalents and, thus, the transaction failed the continuity of interest test.

or (iii), either that the transferee thrift is insolvent, the assets of the thrift are substantially dissipated, or the thrift is in an unsafe and unsound condition to conduct business. The Bank Board, the Federal Savings and Loan Insurance Corporation ("FSLIC") or, if neither has supervisory authority over the thrift, the equivalent state authority may certify that one of the grounds specified in 12 U.S.C. § 1464(d)(6)(A) exists. In addition, section 382(b)(7)(B) was added to provide that the transferee's and transferor's depositors are taken into account in determining the level of continuity of interest for purposes of section 381.

In these acquisitions a profitable financial institution typically agrees to assume the transferor thrift's obligations in consideration for payments from a regulatory body such as the FSLIC, and the right to succeed to the transferor's tax attributes. The tax attributes which the acquiring corporation seeks to preserve are the thrift's accumulated net operating losses and other carryforwards and the transferor thrift's basis in its assets (typically residential mortgages with basis significantly above fair market value).[8]

In tax-free reorganizations the continuity of interest requirement limits tax-free treatment to those transactions in which the owners of the target corporation receive a meaningful ownership interest in the acquiring corporation. The transfer of stock in the target corporation for stock in the acquiring corporation is tax-free because the owners of the target corporation are deemed to have merely changed the form of their investment. Moreover, the notion that tax attributes carry over in a tax-free reorganization hinges on the continuity of interest doctrine. The tax law considers it appropriate for tax attributes to be used to offset income earned after the acquisition whenever the historic shareholders who incurred the unused attributes continue to hold a sufficient equity position after the reorganization.

Under the revised rules for thrifts, neither the stockholders nor the creditors (*i.e.*, the depositors) of the troubled thrift receive a continuing ownership interest in the acquiring corporation. To permit tax attributes to carry over in these transactions thus departs from the traditional principles underlying the tax-free reorganization provisions, and provides a tax subsidy for private acquisitions of thrift institutions. In effect, this subsidy may operate to shift some or all of the burden of thrift losses from FSLIC, the private insurance agency funded by the thrift industry, to the Federal government. Congress thus should consider carefully whether subsidies for the thrift industry are necessary, and whether they should be made through direct appropriations or through the tax laws, recognizing that the latter route may be less efficient and more costly in the long run. We recognize, however, that the thrift industry is undergoing a period of restructuring and there may be nontax considerations for encouraging the flow of capital into the thrift industry.

If the thrift reorganization rules are retained, we also suggest that these Committees examine whether the special thrift reorganization rules should be limited to acquisitions of a thrift by a bank or another thrift. These provisions were enacted to facilitate the rehabilitation of a thrift through its acquisition by another thrift under the supervisory powers of a certifying agency. Although the statutory language and the legislative history do not explicitly suggest that these provisions are limited to acquisitions of troubled thrifts by other depository institutions, strong concerns existed in 1981 that these special rules not be used to permit the ready transfer of realized and built-in losses of a troubled thrift to a corporation other than a depository institution. Indeed, the Bank Board, in seeking this legislation, assured the staffs of the tax-writing committees and the Treasury Department that the principal purpose of the legislation was to remove the technical obstacles to supervised mergers involving troubled thrift institutions.

We have become aware that these special rules are being used increasingly to facilitate mergers of troubled thrifts and corporations outside the banking sector. Though these acquisitions may technically satisfy the statutory requirements, the potential transfer of tax losses of troubled thrift institutions to corporations other than banks or other thrifts goes beyond the intended scope of the ERTA provisions. To date, the Internal Revenue Service has not issued ruling involving troubled thrifts where the principal trade or business of the acquiring corporation is unrelated to banking. Thus, if thrift reorganizations are to be continued, we urge that Congress clarify the scope of these provisions.

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[8] This carryover basis would leave the transferee with substantial built-in losses which could be realized merely by selling the loans. Alternatively, if the transferee does not sell the loans, the carryover basis permits the transferee to treat payments other than stated interest as repayments of principal; if the transferee took a fair market value basis in the loans, a portion of the "principal" repayments would constitute market discount under section 1277 and thus be treated as ordinary income.

IV. Current Legislative Proposals

In response to the current flurry of merger and acquisition activity, a number of bills have been introduced in Congress that would use the tax laws to discourage these transactions. I will comment on several of these bills, but will not discuss any of them in detail.

It has been proposed that more stringent tax consequences attach to a stock acquisition that is effected pursuant to a hostile takeover (generally, one disapproved by a majority of the independent members of the board of directors of the target corporation). An automatic section 338 election would be deemed made, and all gain on the target corporation's assets, not just recapture and tax benefit items, would be recognized. We do not believe that the tax laws should be used to discourage hostile takeovers. If it is concluded that hostile takeovers harm shareholders or the economy, Congress should address its concerns directly. As a matter of tax policy we do not believe "hostile" acquisitions should be treated differently under the tax laws than "friendly" acquisitions.

It has also been suggested that so-called "greenmail" profits be subject to a 50 percent excise tax, and that no deductions be allowed for "greenmail payments" or interest on indebtedness incurred to acquire stock or assets acquired pursuant to certain hostile acquistions. While we would not object to a statutory confirmation that under current law "greenmail payments" are not deductible, we do not believe, that there is a need for special tax provisions to curtail greenmail payments.

V. Summary

In conclusion, the current tax rules would not appear to be propelling the recent surge of corporate acquisitions and takeovers. We have set out in this testimony, however, certain aspects of current tax law that may encourage corporate acquisitions and that may be the proper subject of legislative reforms in this area. In particular, we look forward to working with your Committees this year to modify the rules relating to the carry over of corporate tax attributes in mergers and acquisitions. We do not believe, however, that Congress should amend the tax laws for the purpose of generally discouraging merger and acquisition transactions.

This concludes my prepared remarks. I would be happy to respond to your questions.

Chairman PICKLE. We do thank you very much, Mr. Secretary.

I followed your comments, but I still haven't gotten any direction about how you feel we should go. I want to ask a broad question.

In response to your last statement, you said that we ought to do something about these net operating losses that keep carrying over from year to year. Do you have a recommendation?

Mr. PEARLMAN. Yes.

We have previously testified before Ways and Means and given very specific recommendations as to what we think a legislative package should be. We have in addition to that been working with the staff of the Ways and Means Committee so I think there are specific recommendations.

Mr. Pickle, let me respond, if you will, to your original comment because I think it is an understandable comment based both on the written statement and the comments I have made this morning. I believe that our most important responsibility at this hearing is not to come up here urging a certain legislative reaction to a problem which may indeed be much more than a tax problem, particularly when we are not convinced a tax legislative reaction is in order. We begin with a philosophy that we do not believe the tax system should be used to achieve objectives in the context of mergers and acquisitions that is not a tax objective.

The tax system, we believe, is not the place to do that. We did think it is our responsibility to try to help the subcommittee identify areas where the tax system was undoubtedly having an influence on merger and acquisition activity. We tried in the written

statement to point out those areas and we have raised some concerns and to the extent now, based on the materials that we have submitted others, if we can become more specific with you and react more specifically to particular legislative initiatives or to provide additional data, obviously we will be happy to do so.

Chairman PICKLE. Well, I can understand your attitude and I am sure you understand our concern, that here is a burning public issue but everybody sniffs and looks the other way. We have to ask ourselves if this is correct.

The Oversight Subcommittee wrote you on March 18 and asked you to list for us the last 10 major acquisitions or mergers, how they were financed, what Tax Code provision was utilized, the amount of profit realized to the acquirer, how the profit was taxed, if it was taxed, or if you know in effect where the money went.

Now we asked you for that information on March 18. That is asking for a lot in 2 weeks' time, and I know you couldn't get that information to us, and we assume you need more time. I assume you do not have that information now; is that correct?

Mr. PEARLMAN. That is correct. We are happy to try to help develop that information. We hope that perhaps we can work with the joint committee in developing that information together. One of the problems we have is that this is not information, as I am sure you are aware, that is available through tax returns. Many of those transactions have not yet been the subject of tax return reporting so our information is no better than anyone else's. That is, we have to go out and either talk to the people who represent those companies or get the materials that were publicly filed and so it is a major job for us because we have no unique source of that information.

We took your letter seriously and intend to develop that information and I hope you will bear with us until we can put it together.

Chairman PICKLE. We will bear with you up to a point, Mr. Secretary. Put yourself in our position. The only Department in all of Government who knows whether there has been the use of the Tax Code in these acquisitions and mergers is the Treasury Department through the Internal Revenue Service. Nobody else knows that. We can speculate on it, but we don't have the black and whites before us. You do have.

For that reason, you don't have to wonder and speculate. You do have to go out and ask for information if the tax returns are not in, but for those that are in and some of the major ones ocurring in the years, say, 1982, 1983, and 1984, should be in.

Now, we want that information, not in detail, but in general summation, because you are the only one that has it and you are the only one who can tell us. But if we don't get it, we are going to come down and get it.

Mr. PEARLMAN. I don't want to leave any misimpression. We absolutely intend to provide the data to you. I don't want to indicate any lack of cooperation.

Chairman PICKLE. I don't question that. I am trying to impress on you the fact that we need to look at how this is going on, what is happening and is it good or is it bad, so we don't have to speculate about it. Then we know whether it is good or bad for the country so we can make a judgment. That is all we are asking for.

I get disturbed as one individual—I get concerned, maybe is a better word for it—when one individual makes $100 million on greenmail or if another makes $700 million on greenmail. Now, whence goeth that money? Do you think for a moment that the individual pays ordinary tax on that $700 million? I don't think you think so for a moment and neither do I.

But you have to ask yourself, if these kinds of enormous sums are being made through greenmail, is Uncle Sam getting its just portion?

You are the only one that has that information, so I ask you, not to tell us—the baking powder company, company A, B, C, one, two, three, but instead for a summation of what is taking place in the market. We are going to have another hearing on April 16. Can you have some summation of those ten corporations by then?

Mr. PEARLMAN. Let us see what we can provide you by April 16.

Chairman PICKLE. Mr. Anthony, you had questions on ESOP's?

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Pearlman, I would like to direct your attention to pages 16, 17, and 18 of your testimony and try to clarify some confusion that I have. On page 16, you state that leverage buyouts are primarily motivated by economic factors. Then on page 17, you say the Treasury has particular concerns about the use of ESOP's to effectuate such buyouts. That leaves me with the following question. Why is a leverage buyout that is done for economic reasons good when the purchase is by a small group of investors and bad when employees participate in the purchase of economically profitable companies?

Mr. PEARLMAN. Well, to the extent that we left that impression in the written statement, I don't think we should have. I do not think that there should be a difference. I don't think one is bad or one is good. I think that the concern that we have with the ESOP is simply when you add to the use of tax benefits of a leveraged transaction a number of additional benefits, do you drive—is it more likely, (a) that that transaction will take place; and, (b) will it take place in an uneconomic context.

Example: In a typical leveraged buyout, the purchaser has to go to the bank and borrow and presumably the lender is going to be careful about the borrower's ability to repay and to take care to evaluate the economics of that transaction. Under current law now, an ESOP lender gets a tax benefit to the extent it receives interest income, and the lender may be just as prudent as it would be if it were fully taxable on the interest income.

On the other hand, if it looks at that loan to an ESOP as being a pretty attractive loan to make, its standard in terms of evaluating that loan may go down. It may look at that transaction with a bit less care because it knows it is getting a substantial benefit from receiving some of the interest income tax free.

I am not suggesting that would or would not change the way it would evaluate the transaction but simply that it may. We are saying that while on the one hand clearly the Congress intended to encourage increased employee ownership through ESOP's, we have to be careful that we are not forcing the parties to the transaction to enter into uneconomic behavior by a set of tax incentives that are not available even in the standard leveraged buyout.

I would not want to suggest that an acquisition by a group of employees is any less desirable than any other type of action.

Mr. ANTHONY. So on page 18 you would use the same logic to massage my concerns a little bit in saying that there is uncertainty about current benefits that an ESOP would have for employees. What triggers in my mind concerns the current benefits employees receive if they have a band of corporate raiders owning it, with the stock concentrated with a few people versus the future benefits of spreading the stock ownership to the employees. Employees involved in an ESOP do not actually put up cash, but do receive the benefits of ownership. In other words, the longer the employees work for the company, they benefit, and as they retire it does become a defined benefit.

Mr. PEARLMAN. The point we try to make on page 18 deals with the distance of the employee to the investment. Certainly you could do, and people did for years, leveraged acquisitions by groups of employees before there was anything known as the employee stock ownership plan, where the elder generation of management would sell the business to the next generation of management, it was a very common acquisition technique and it was one in which the earnings of the business ultimately were used to buy out the older shareholders as they retire.

There were no ESOP's involved, it was just done under current law. In that case, the group of employees who then ended up as the next generation of owners had a very direct impact on them if there were earnings in that business, those earnings were as close as the share of stock, the ability to declare dividends. They had voting rights in the stock, they were managers or corporate shareholders in the real sense of the word.

One of the things that happens with the leveraged ESOP is that might not be the case. One thing we know for sure is that there is an interposed entity, the employee may not know he has a share of stock, that stock is owned by a trust on behalf of the employee, dividends that go into the trust are going to be used to pay off the debt and the key thing it seems to me is that that employee doesn't get his hands on that stock until he separates from service and in many cases, if you are talking about a nonpublicly traded ESOP, it has very limited voting rights.

One of the things of concern to me is do the ESOP provisions create too much of a distance between the real owner employees and the transaction to make sure that the leveraged ESOP is achieving the objective that I think the Congress wanted, that was to convey—to encourage employee ownership in the most economically efficient way, if you will, and I am not making a value judgment, I am not saying it is or it isn't, but I think it is an area that I think one must look at in a merger analysis.

Mr. ANTHONY. I just have a few follow-up comments.

I think it would be inconsistent, and it would be a very incompetent management that would let employees have a trust whereby they could own stock in a company and then not tell them, and I think you would have a pretty damn dumb work force if they owned stock in a company and they didn't know it. There would be a big slip between the cup and the lip if that occurred. Also on your dividend position, the dividend does not necessarily have to go

into the trust. The dividend can pass directly through to the employee.

If I were a manager, I would want to pass it through so I could service the debt. It would certainly encourage that employee to be more productive, to show up Monday morning, to work 40 hours, and to do well knowing in the final analysis when he retires, his stock would be worth a lot more than the day the stock ownership started.

But it seems to me terribly confusing, if not contradictory for Treasury to take this position at a merger and acquisition hearing knowing that these provisions were put into the Tax Code only last year in 1984. I am curious to whether or not the record is complete with the Treasury's concerns and worries about these additional incentives being placed. It seems to me we can broaden the capital ownership in this country rather than concentrating it.

We are hearing that the public has concerns about constricting capital ownership rather than broadening it. In my opinion, ESOP's give you the ability to broaden capital ownership.

I would say that I do agree with the comment that you made a while ago. We are not sure what the final implications are going to be for the 1984 tax changes. In our reorganization meeting, I suggested to the chairman that we should take a look at the implications of the 1984 tax changes, and at a minimum I agree with your testimony on that point.

I also agree with your analysis that as more people learn about ESOP's, they are probably going to be utilized more. I don't think this fact should be cast in a negative light. At least we ought to stay neutral until we see what the record shows.

I encourage the chairman of the committee to work with you and GAO to see exactly what the implications are. I look forward to working with you and I thank you for clarifying the statement.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Mr. ANTHONY. Would you pass that gavel down here to me, please.

Mr. SCHULZE. I don't know whether you were here earlier when we were talking about methods of preventing or delaying hostile takeovers. In your testimony, you said that from a tax standpoint we should not get involved and I agree with you.

Are you familiar with the legislation which has been alluded to and mentioned?

Mr. PEARLMAN. Yes.

Mr. SCHULZE. I have a great concern which I did voice earlier that certain members of a board would have undue consideration or leverage over tax policies if such legislation were passed. Do you share my concern in that area? Do you believe a few members of a board should be given the right, in effect, to dictate tax policy?

Put another way, a nongovernmental entity, in effect, sets the policy for that transaction.

Mr. PEARLMAN. Well, I certainly do agree with you—I would generalize your statement to say that to the extent that we—that the Congress were to legislate in a way that put tax impediments in front of certain kinds of—say, certain kinds of mergers, some were good and some were bad, then that clearly is going to have an

impact on what hopefully we would conclude is good decisionmaking, good at least in the form of being independent decisionmaking by boards of directors. I find that troublesome.

I think that we should try to get away from not increasing the extent to which the tax system interferes with business decisionmaking. I do not think that is desirable. We at Treasury feel very strongly about that.

You raised the additional point that if you really go down this line of hostile versus friendly and if you try to seek to define that, are you not going to permit certain members of management or the board to cross that line. I guess, Mr. Schulze, that would be very disturbing and I would think that we just simply couldn't do that.

We would have to redefine those terms in a way that we can't let that happen and that is one of the great difficulties here, what might seem hostile or friendly today turns out to be different three weeks later in the negotiations and it would be a very difficult line to go down.

Mr. MCGRATH. Would the gentleman yield on that point?

I think in all the discussion today regarding hostile takeovers, there really hasn't been any mention of what the definition between hostile and friendly might be. It seems to me it is just a matter of price. Sooner or later any matter of tax policy that treats various types of acquisitions differently is patently unfair.

Mr. SCHULZE. I agree, and I thank the gentleman.

Ron, in the information requested by the chairman, he asked you for the 10 or so largest acquisitions. It would be helpful if when gathering that information, we could put that in perspective. I don't think we ought to deal necessarily only in the large acquisitions and mergers, but also to understand those ramificiations across the board. Could you give us some perspective, without a great deal of additional effort, as to dollar values of other mergers and acquisitions, and the overall numbers of mergers and acquisitions. I would appreciate very much having that information.

It is going to take a lot of extra time and effort, but if you could give us a general idea, it would be helpful.

Mr. PEARLMAN. We will be glad to.

Chairman PICKLE. Mr. Secretary, we have a lot of questions that we would like to submit to you in writing and ask you to respond to us between now and the next hearing, the 16th. Tomorrow we have a full schedule.

I know this is a difficult area and perhaps you are correct—you get into double taxation of corporations and that gets to be kind of the root problem.

The President's proposal, or rather the first Treasury proposal, whosoever it was, had recommended a corporate deduction of 50-percent dividends paid.

Now, as I understand it, that part of the package will not be included in the measure that is going to be submitted on May 1st.

Now, Mr. Brockway had testified here earlier this morning that if you did have this 50-percent dividend deduction, that that could go a long distance in alleviating the double taxation of equity capital, and perhaps that might be a good way to go about it. Is there

a division in that? Can you tell us why that might be left out of the package?

Mr. PEARLMAN. There is not much I can say but any reports that it is not going to be in the package are not accurate. The President has not made that decision. We feel at Treasury that dividend relief should be part of the package and it is my hope that that will be part of our recommendation to the President, but those decisions have not been made, so to the extent that people are reporting one way or another, they are simply inaccurate reports.

Chairman PICKLE. Is there some opposition from corporations?

Mr. PEARLMAN. No; we have gotten positive responses from corporations. The original word was that corporations were opposed to dividend relief, but we have not found that to be the case and a large number have indicated support for that proposal. I think this provision, to the extent that it gets negative comments, has nothing to do with the merits, but has to do with revenue implictions, that if you want to do something else in a revised tax system, here is a way to pick up money to be used for doing something else.

Chairman PICKLE. Thank you. We appreciate your testimony and your patience today. We will be submitting additional questions.

Mr. PEARLMAN. Thank you very much.

[The questions follow:]

COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC, May 13, 1985.

Mr. RONALD A. PEARLMAN,
Assistant Secretary for Tax Policy,
U.S. Department of Treasury,
Washington, DC.

DEAR MR. PEARLMAN: Thank you for appearing as a witness at the Subcommittee's hearing on mergers and acquisitions. Your experience and expertise provided the Subcommittee with much valuable analysis and information. For the purpose of completing the Subcommittee's hearing record, I have enclosed a series of additional questions for your response.

I would appreciate your review and response to my office by May 24, 1985. If you have any questions, please contact Bill Cunningham of the Subcommittee staff at 225-5522.

Sincerely yours,

J.J. PICKLE,
Chairman, Subcommittee on Oversight.

Enclosures.

1. In addition to information which was requested from Treasury during the April 1, 1985 hearing, please provide the data and analysis the Oversight Subcommittee Chairman requested by letter of March 18, 1985. (The Department of Treasury has been requested to provide the Subcommittee with information relating to the ten largest mergers in recent months, including how they were financed; what tax code provisions were utilized; the amount of profit realized by the acquirers; and how any profit was taxed.)

2. Does the Department of Treasury feel that the tax laws encourage or influence mergers? If so, which provisions are primarily used by the parties involved in mergers? Should the tax code be neutral toward mergers? If yes, which provisions of the tax code should be changed and how?

3. Some experts argue that the tax laws encourage debt financing rather than equity financing since corporations are allowed deductions for interest payments but not for payment of dividends.

(a) Does Treasury agree?

(b) Should the Congress restrict or eliminate the deductibility of interest (1) generally; (2) in all mergers; (3) in "hostile takeovers"; or (4) for "junk bonds"? Please explain.

4. If a line were to be drawn for tax purposes between friendly mergers and hostile mergers, how should hostile be defined? Should a vote by the "independent directors" of the target corporation be dèterminative? If not, what test or standard should we use? Should the tax code distinguish between hostile and friendly mergers?

5. If the deduction for interest payments on junk bonds were denied, does Treasury feel that such denial should apply:

(a) To all junk bonds;

(b) To junk bonds used in connection with any merger or acquisition;

(c) To junk bonds used in connection with any larger merger or acquisition;

(d) To junk bonds used by any target company to repurchase its own stock.

Please explain your answer.

6. How would Treasury define a "junk bond" for tax code purposes? Are there other debt or equity instruments with similar characteristics to those of junk bonds that we should be concerned about in evaluating the deductibility of interest?

7. Does the election under Section 338 of the Internal Revenue Code to step up the basis of assets cause mergers to happen or does it instead influence the form of the merger?

8. Does Treasury feel that any changes should be made to Section 336, Section 337 or Section 338 of the Code? If so, what would you recommend?

9. Some experts argue that certain mergers are driven by profitable corporations seeking to offset their income by acquiring firms with net operating losses. Should the Congress address as a priority modification of Section 382 of the Code? If so, what recommendations do you have?

10. Should greenmail payments be prohibited or penalized? If so, should such regulation be done through the securities laws and/or the tax laws? Does Treasury have any recommendations for regulating greenmail payments through the tax code? How would Treasury define "greenmail"?

11. In many respects the tax laws are arguably not neutral with regard to mergers and acquisitions.

(a) If the deductibility of interest was prohibited in connection with all mergers and acquisitions, what impact would this have on Federal revenues?

(b) If the Section 338 election was eliminated, what impact would this have on Federal revenues?

(c) If the rules allowing for the carryover of net operating losses were eliminated or further restricted, what impact would this have on Federal revenues?

12. Reports indicate that some target corporations are deducting greenmail payments, in whole or in part, as an ordinary and necessary business expense under Section 162 of the Code.

(a) Are such deductions allowable?

(b) What position has the IRS taken on the deductibility of "greenmail" payments?

(c) Is legislation necessary to resolve this issue?

13. Treasury's general conclusion is that the tax laws probably do not drive merger and acquisition activities. At the April 1, 1985, hearing, Congressman Flippo requested documentation supporting that conclusion. Please provide that documentation.

[Treasury's response follows. Additional information was not supplied to the subcommittee as requested.]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

AUG 02 1985

Dear Mr. Pickle:

You have asked us for a description of (1) the general background of the last ten major merger transactions, (2) how such mergers were financed, (3) what tax code provisions were utilized, and (4) the amount of profit realized to the acquired company's shareholders, how it was taxed and where the money went. Finally, you asked for our views on options the Subcommittee might consider to make the tax code neutral with regard to merger transactions and whether any such changes would be appropriate.

In order to comply with your request for a description of the last ten major mergers, we have selected the following ten largest transactions by purchase price in 1984:

10 LARGEST TRANSACTIONS BY PURCHASE PRICE 1984 */

Acquiring Company	Acquired/Merged Company	Value $ Millions
1. Chevron Corp.	Gulf Corp.	13,300.0
2. Texaco Inc.	Getty Oil Co.	10,125.0
3. Mobil Corp.	Superior Oil Co.	5,700.0
4. Kiewit-Murdock Investment Corp.	Continental Group, Inc.	2,570.0
5. Beatrice Cos. Inc.	Esmark Inc.	2,710.0
6. General Motors Corp.	Electronic Data Systems Corp.	2,600.7
7. Broken Hill Proprietary Co.	Utah International Co.	2,400.0
8. Champion International Corp.	St. Regis Corp.	1,826.9
9. Phillips Petroleum Co.	Energy Operations of R.J. Reynolds Industries Inc.	1,700.0
10. Manufacturers Hanover Corp.	C.I.T. Financial Corp.	1,510.0

*/ Source: 19 Mergers & Acquisitions 27 (1985).

The acquisitions for 1984 were selected because such acquisitions are the most recent completed acquisitions that are affected by the significant corporate tax changes enacted by Congress as part of the Tax Equity and Fiscal Responsibility Act of 1982 (but generally not the changes made by the Tax Reform Act of 1984) and for which significant data is readily available. However, because of how recent the acquisitions occurred, no tax return information for any of the parties to the acquisition is readily available. The attached information is drawn solely from published sources, primarily documents filed with the Securities and Exchange Commission. We do not know and are unable to determine whether these transactions are representative of merger activity in general either in 1984 or currently.

As you know, we have testified at a hearing held jointly by your Subcommittee and the Subcommittee on Select Revenue Measures on April 1, 1985, and at a hearing held by the Senate Finance Committee's Subcommittee on Taxation and Debt Management on April 22, 1985. In the statements submitted at those hearings, we discussed in great detail all of the tax code provisions that govern merger and acquisition transactions, examined certain structural aspects of the tax code that may encourage corporate acquisitions and takeovers, pointed out a number of provisions Congress may wish to consider removing or modifying, and analyzed certain recent trends in corporate acquisitions that raise significant tax policy issues. Finally, we discussed and presented our views on a number of bills currently pending in both the House and Senate. For your convenience, I have attached a copy of those statements. We found nothing in the attached descriptions of ten major mergers that would change our earlier analysis.

I hope the attached information is helpful to you.

Sincerely,

Ronald A. Pearlman
Assistant Secretary
(Tax Policy)

Attachments

The Honorable J. J. Pickle
Chairman
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

DESCRIPTION OF TEN LARGEST MERGERS IN 1984

As discussed in the accompanying letter, in order to comply with your request for a description of the last ten major mergers, we have selected the ten largest transactions by purchase price in 1984 as reported in Mergers and Acquisitions magazine. To the extent we could readily obtain the information you requested, it is contained below. Because of how recent these transactions occurred, however, no tax return information for any of the parties to the acquisitions is readily available. Accordingly, the following information is drawn solely from published sources, primarily documents filed with the Securities and Exchange Commission.

1. Chevron Corp. - Gulf Corp.

A. General Background of Acquisition

Standard Oil of California ("Chevron") is a major international oil company engaged in worldwide integrated petroleum operations which consist of exploring for and developing crude oil and natural gas reserves, transporting crude oil, natural gas and petroleum products by pipelines, oil tankers and motor equipment, operating large refinery complexes for converting crude oil to finished products, and marketing at wholesale and retail the many products derived from petroleum. Chevron also has interests in numerous plants located around the

world which produce a wide range of chemicals and fertilizers for industry, farms, homes and gardens. Chevron also engages in real estate development and is involved in minerals exploration and projects related to synthetic fuels and alternate energy resources such as shale oil and geothermal. Gulf was a major integrated petroleum company engaged principally in the exploration for, and production, purchase, transportation, refining and marketing of crude oil, natural gas and natural gas liquids, and the transportation, refining and marketing of products derived therefrom. Gulf also received revenues from other activities, including chemicals and coal, and other non-petroleum products and services.

On February 23, 1984, Mesa Petroleum Co. and other members of an investor group made a tender offer to purchase approximately 8.3% of the Gulf stock for $65 per share. The next day, the Board of Directors of Gulf determined that the $65 offer was unfair and recommended that Gulf's shareholders reject the Mesa offer.

Subsequently, Gulf entered into a merger agreement with Chevron on March 5, 1984, pursuant to which Chevron made a tender offer to acquire all of the outstanding Gulf common stock, $1 par value per share, for a price of $80 per share. Chevron purchased all of the approximately 137,000,000 shares (approximately 83% of the then outstanding shares) tendered to it pursuant to the offer, which expired on May 4, 1984. On June 15, 1984, following

approval of Gulf shareholders, a subsidiary of Chevron formed for the purpose of the acquisition was merged with and into Gulf, making Gulf a wholly-owned subsidiary of Chevron and forcing out all of the remaining shareholders of Gulf other than Chevron. The total cost to Chevron of the Gulf stock was $13.235 billion and an allowance of $65 million for other direct acquisition costs including investment banking fees, SEC filing fees and legal fees.

After taking into account Chevron's purchase accounting adjustments, related tax effects, and financing costs associated with the acquisition, Gulf contributed $40 million to Chevron's earnings for 1984. Chevron began including Gulf's results beginning May 1, 1984.

B. Financing of Acquisition

Chevron obtained funds to buy Gulf from its general corporate funds and through borrowings from various commercial banks, with the majority of the funds coming from a credit agreement dated March 9, 1984 with a number of banks providing for loans of up to a total of $14 billion. These borrowings under the credit agreement are unsecured. The credit agreement is an eight-year revolving credit/loan facility, with the first two years being a revolving credit facility. Amounts outstanding at the end of two years are repayable thereafter in eight equal semiannual installments, commencing 4-1/2 years after the date of the credit

agreement. The loans bear interest at either (i) the domestic certificate of deposit rate (the "CD Rate") plus 1/2% per annum for years one through four, and the CD Rate plus 5/8% per annum for years five through eight or (ii) the London interbank offered rate plus 3/8% per annum for years five through eight. As of April 26, 1984, the rate of borrowings under the credit agreement were between 11% and 12%.

During the fourth quarter of 1984, Chevron continued restructuring the debt incurred to acquire Gulf by converting a part of the short-term floating rate borrowings into $1.6 billion of fixed rate notes. The fourth quarter refinancing consisted of $600 million of Eurodollar notes and $1 billion of domestic notes in two issues of $500 million each. In 1984, Chevron issued $2.6 billion of notes in restructuring the initial debt associated with the Gulf acquisition.

Financing costs related to the acquisition totaled $541 million for 1984. Chevron's interest and debt expense for 1984, the year of the merger, was $961 million, compared to a $75 million interest and debt expense in 1983.

In addition, pursuant to another credit agreement dated June 14, 1984, between subsidiaries of Chevron and Gulf, Chevron can borrow up to $2 billion from Gulf. As of June 30, 1984, approximately $1.1 billion had been borrowed under such an agreement. These loans will be unsecured and at a rate of

interest based on the 30 day commercial paper rate of the General Motors Acceptance Corporation.

C. What Tax Code Provisions Were Utilized

The acquisition took the form of a taxable stock acquisition. We are unable to determine whether Chevron will make a section 338 election for the acquisition of Gulf. In addition, we are unable to determine whether Chevron or Gulf had net operating losses, "built-in losses," or unused tax credits at the time of the merger.

D. Amount of Profit Realized to the Acquired Company's Shareholders

Since Gulf was a publicly held company, we are unable to determine the amount of profit realized to the acquired company's shareholders. In addition, we are unable to readily determine the amount of profit realized to the Mesa Petroleum investor group.

2. Texaco Inc. - Getty Oil Co.

A. General Background of Acquisition

Texaco and its subsidiaries represent a vertically integrated enterprise principally involved in the petroleum and natural gas

business, including petrochemicals. It is engaged in worldwide exploration for and production, transportation, refining and marketing of crude oil and its products, including petrochemicals. Getty was an integrated petroleum company primarily involved in the search for and production of crude oil and natural gas, as well as the transportation, manufacturing, and marketing of petroleum and petroleum products and other minerals. Addiitional activities included chemical manufacturing and marketing, property and casualty reinsurance and life insurance, television sports programming, agricultural production, and real estate and forest products properties.

On December 28, 1983, Pennzoil made an offer to purchaser Getty. On January 4, 1984, Pennzoil announced that it and the Sara C. Getty Trust (the "Trust") (which owned approximately 11.8% of the outstanding stock) would acquire Getty in a transaction in which the stockholders of Getty, other than Pennzoil and the Trust, would receive $110 per share in cash and additional consideration equal to a pro rata share of the net after tax proceeds, in excess of $1 billion, from the proposed disposition of ERC Corporation, a reinsurance subsidiary of Getty. The additional cash consideration was not to have been less than $5 per share and would have been paid within five years.

Within days following the Pennzoil offer, Texaco was contacted by representatives of Getty and the J. Paul Getty Trust

(the "Museum") and investment bankers to explore whether Texaco was interested in acquiring Getty. On January 5, 1984, the Texaco Board of Directors authorized management to take action as necessary to acquire the entire equity interest in Getty.

On January 9, 1985, a wholly-owned subsidiary of Texaco offered to purchase up to 28,000,000 shares of Getty common stock without per value. The offering price was $125 per share. The shares which were the subject of the offer constituted approximately 35.4% of the shares of Getty stock outstanding on January 5, 1984. Texaco had previously agreed to purchase for approximately $125 per share a total of 41,125,428 additional shares of Getty stock (9,320,340 shares (11.8% of the outstanding stock) from the J. Paul Getty Trust and 31,805,088 (40.2% of the outstanding stock) from the Sara C. Getty Trust) which, together with the shares of stock sought in the offer, would constitute approximately 87.4% of the outstanding stock. Getty had also granted Texaco an option to purchase 9,000,000 authorized but unissued shares pursuant to an option at a price of $125 per share in cash. Following the expiration of the tender offer, a wholly-owned subsidiary of Texaco merged with Getty to squeeze out the remaining shareholders of Getty other than Texaco. The total cost of the acquisition was approximately $10.125 billion.

B. Financing of Acquisition

The total amount of funds required by Texaco's subsidiary to purchase 28,000,000 shares of Getty stock pursuant to the offer was expected to be approximately $3.5 billion (approximately $4.75 billion if all outstanding stock (other than the Trusts' stock) was purchased pursuant to the offer). Texaco's subsidiary obtained the necessary funds from Texaco by means of a combination of equity contributions and loans. Texaco obtained these funds through borrowings from various commercial banks and from its general corporate funds.

Texaco had commitments from various banks to lend Texaco amounts substantially exceeding $4.75 billion on an unsecured basis. The loans were to take the form of an eight-year Revolving Credit/Term Loan Facility. The funds obtained pursuant to the loans were to bear interest, at Texaco's option at either (i) the domestic Certificate of Deposit Rate (the "CD Rate") plus 1/2% for years one through five, and the CD Rate plus 5/8% for years six through eight, or (ii) the London interbank offered rate ("LIBOR") plus 3/8% for years one through five and LIBOR plus 1/2% for years six through eight. At the time of the Offer to Purchase, Texaco had not determined how the loans would be repaid or refinanced. It was expected that they would be repaid from general corporate funds (including funds generated by the operations of Getty) or other sources, including the sale of assets of Texaco and Getty and the proceeds of private or public long-term or short-term borrowings. No estimate of the resulting interest deduction for federal tax purposes is readily available.

C. What Tax Code Provisions Were Utilized

The acquisition took the form of a taxable stock acquisition. We are unable to determine whether Texaco will make a section 338 election for the acquisition of Getty. In addition, we are unable to obtain information with regard to the tax attributes of any party to the transaction.

D. Amount of Profit Realized to the Acquired Company's Shareholders

Since Texaco was a publicly held company, we are unable to determine the amount of profit realized to the acquired company's public shareholders. In addition, we are unable to obtain information with regard to the amount of profit realized by the Getty trusts.

3. Mobil Corp. - Superior Oil Co.

A. General Background of Acquisition

Mobil Corporation is primarily a holding company, whose principal business, conducted through its wholly owned subsidiary, Mobil Oil Corporation, is to conduct an integrated petroleum business in the United States and through affiliates throughout the world. These activities include the exploration, production, transportation, refining and marketing of petroleum

and natural gas and the manufacture and marketing of chemicals. In addition, Mobil is involved, through other subsidiaries, in retail merchandising and paperboard packaging. Superior Oil Co. and its subsidiaries are primarily engaged in the exploration, development, and production of natural resources, principally oil and gas, and are also involved in contract drilling, mining of coal and hard rock minerals and agriculture.

On March 11, 1984, Mobil concluded agreements with certain shareholders of Superior pursuant to which Mobil acquired 28,717,398 shares of Superior at approximately $45 per share. Such shares represent approximately 22.6% of the 127,249,626 shares outstanding on March 15, 1984. The bulk of these shares (18.7% of the Superior shares outstanding) were acquired from Mr. Howard B. Keck, who had been Chairman of the Board of Superior. On March 11, 1984, Mobil and Superior also entered into a stock option agreement pursuant to which Superior granted Mobil an option to purchase at $45 per share in cash 8,650,000 authorized but unissued shares, which would represent approximately 6.4% of the shares outstanding, assuming the option were exercised. Also on this date, Mobil commenced a tender offer for up to 36,000,000 outstanding shares of Superior common stock, par value $0.10 per share (which, when combined with stock owned by Mobil, represented approximately 51% of the share of Superior as of that date) for a combination of cash and debentures.

On March 29 and 30, 1984, Mobil acquired an aggregate of

360,700 shares of Superior in open market transactions at an average cost (including commissions) of $41.56 per share.

On June 20, 1984, Mobil announced the acceptance of 36 million tendered shares of Superior, for which $720 million of cash and $900 million of 14.40% Debentures due in 2004 were exchanged. Mobil may redeem these Debentures after 1989 and prior to maturity, at a redemption price equal to 100% of the principal amount to be redeemed, together with accrued interest. The debentures are also entitled to the benefits of a mandatory sinking fund.

On June 21 and 22, 1984, Mobil acquired an additional 11 million shares in transactions on the New York Stock Exchange for $466 million of cash, bringing Mobil's ownership in Superior to approximately 60%.

On September 20, 1984, Superior shareholders approved a merger agreement between Mobil and Superior, which became effective on September 28, 1984. As a result of the merger agreement, $1.022 billion of cash and $1.278 billion of 13.765% Debentures due 2004 were exchanged for the remaining shares of Superior. The total cost of acquiring Superior was $5.720 billion.

Superior has been consolidated in the financial statements of Mobil since July 1, 1984. Superior's operations, after purchase

accounting adjustments, contributed $91 million in 1984; the adverse effect of the acquisition of Superior, after financing, amounted to $82 million.

B. Financing of Acquisition

In addition to the above described $900 million of 14.40% Debentures due in 2004 issued for the tendered Superior shares, and the $1.278 billion of 13.765% Debentures due 2004 issued pursuant to the merger agreement, on March 20, 1984, Mobil borrowed an aggregate principal amount of $2.7 billion under separate agreement with nine banks providing for such borrowings by Mobil on an unsecured basis, with interest payable at rates ranging from 10% to 10.5625% per annum. Such agreements were replaced by four-year revolving credit arrangements with eight banks pursuant to which $2.5 billion of such borrowings were refunded on March 30, 1984. Interest on borrowings under such credits are based on the London Interbank Offered Rate or the domestic Certificate of Deposit Rate as selected from time to time by Mobil. Mobil is considering various alternatives for financing or repayment of such borrowing, but no decision had been indicated in the documents we examined.

C. What Tax Code Provisions Were Utilized

The acquisition took the form of a taxable stock acquisition. We are unable to determine whether Mobil will make a section 338

election for the acquisition of Superior. In addition, we are unable to determine whether Mobil or Superior had any net operating losses, "built-in losses," or unused credits at the time of the acquisition.

D. Amount of Profit Realized to the Acquired Company's Shareholders

Since Superior was a publicly held company, we are unable to determine the amount of profit realized to the acquired company's public shareholders. In addition, we are unable to obtain information with regard to the amount of profit realized by Mr. Howard B. Keck or other Superior insiders.

4. Kiewit-Murdock Investment Corp. - Continental Group, Inc.

A. General Background of Acquisition

Kiewit-Murdock Investment Corporation is a recently formed entity organized for the purpose of acquiring Continental Group, Inc. and is 80% owned by Peter Kiewit Sons', Inc. and 20% by Pacific Holding Corporation. Peter Kiewit Sons', Inc. is wholly owned by its employees and is a holding and management services company engaged primarily, through various subsidiaries, in construction, coal mining and financial services and, to a lesser extent, in insurance and bonding. Pacific Holding Corporation is indirectly wholly owned by David H. Murdock and is a diversified

company engaged primarily in textiles, vitrified clay products and warehousing. Pacific Holding Corporation also engages in real estate investments and holds interests in other corporations, including an approximate 35% interest in Flexi-Van Corporation, an international equipment leasing corporation. The Continental Group, Inc. is a highly diversified company, engaged, through its subsidiaries, in the businesses of packaging, forest products, insurance, pipeline operations, exploration and production of oil and natural gas.

On June 5, 1984, Continental Group, Inc. received an unsolicited request to commence discussions concerning a business combination between it and Diamond Lands Corporation in which the holders of Continental's common stock would receive in cash $50 per share. Diamond indicated that it was in the process of negotiating financing arrangements for the transaction. Discussions were commenced with Diamond and other companies (including Tenneco Inc. and Kiewit-Murdock) were actively solicited to submit offers for Continental. At a special Board of Directors meeting of Continental on June 29, 1985, a revised offer by Diamond, an offer by Tenneco, an offer by Kiewit-Murdock, and two internally developed plans, involving respectively a liquidation of Continental Group and a restructuring of its assets were considered and the offer by Kiewit-Murdock was recommended. Such offer was later approved by the shareholders by causing Continental Group to adopt a merger agreement with Kiewit-Murdock.

On November 1, 1984, Continental Group merged with and into a wholly-owned subsidiary of Kiewit-Murdock pursuant to an Amended and Restated Agreement and Plan of Merger, dated as of June 29, 1984. Pursuant to the Merger Agreement: (1) each outstanding share of Continental Group's common stock, par value $1.00 per share, is converted into the right to receive $58.50 in cash, (2) each outstanding share of Continental Group's $2.00 Cumulative Convertible Preference Stock, Series A is converted into the right to receive $29.25 in cash, and (3) each outstanding share of Continental Group's $2.10 Cumulative Convertible Preference Stock, Series B is converted into the right to receive $43.875 in cash. Each share of Continental Group's $4.50 Cumulative Preference Stock, Series C, is converted into one share of Series C Preference Stock of the subsidiary of Kiewit-Murdock having designations, relative rights, preferences and limitations identical to those of the Series C Preference Stock of Continental Group, and each share of Continental Group's $4.25 Cumulative Preferred Stock is converted into one share of Preferred Stock of Kiewit-Murdock's subsidiary having designations, relative rights, preferences and limitations identical to those of Preferred Stock of Continental Group. The total value of the acquisition was approximately $2.57 billion.

B. Financing of Acquisition

Kiewit-Murdock obtained financing for the acquisition through a credit agreement with Morgan Guaranty Trust Company of New

York, as agent, and a syndicate of 19 domestic and foreign banks. This financing is being used to prepay certain outstanding debt of the Continental Group and for the cash purchase price of Continental Group. Under the revolving credit portion of the credit agreement, Kiewit-Murdock was able to borrow up to an aggregate of $2 billion through March 29, 1985. Thereafter, the credit agreement automatically converted into a term loan maturing five years from the date of the first borrowing. The borrowings are required to be reduced to $1.5 billion within six months after the first drawdown date. Beginning 18 months from the first drawdown date, semiannual repayments of $125 million are required, with the final amount due five years from the first drawdown date.

Each borrowing by Kiewit-Murdock will bear interest at one of three rates selected by Kiewit-Murdock (plus in each case an amount equal to the appropriate margin as described below): (i) a rate based upon the prime rate of Morgan Guaranty as publicly announced by it from time to time, (ii) a rate based on the average bids made by dealers for Certificates of Deposit issued by certain reference banks for interest periods of 30, 60, 90 or 180 days, plus 0.5%, or (iii) a rate based on the London interbank offered rate of certain reference banks for interest periods of 1, 2, 3, or 6 months, plus 0.375%. The appropriate margin that is added to the above rates ranges between 0.125% and 1%, depending upon the ratio of consolidated total debt to consolidated tangible net worth of Kiewit-Murdock and its

consolidated subsidiaries.

Kiewit-Murdock has indicated that a substantial portion of Continental Group's cash flow after the acquisition will be used for debt service on the indebtedness incurred by Kiewit-Murdock under the above credit agreement. In addition, it is anticipated that some of Continental Group's assets or businesses will be sold after the acquisition to repay some of the acquisition indebtedness.

C. What Tax Code Provisions Were Utilized

The acquisition took the form of a taxable stock acquisition. We are unable to determine whether Kiewit-Murdock will make a section 338 election for the acquisition of Continental Group. In addition, we are unable to determine whether Kiewit-Murdock or Continental Group had net operating losses, "built-in losses," or unused tax credits at the time of the merger.

D. Amount of Profit Realized to the Acquired Company's Shareholders

Since Continental Group was a publicly held company, we are unable to determine the amount of profit realized to the acquired company's shareholders.

5. Beatrice Cos. Inc. - Esmark Inc.

A. General Background of Acquisition

Beatrice Foods Co. is a worldwide marketer of food and consumer products. It produces and distributes food and food-related products, as well as a broad range of non-food related products for use in various consumer, commercial and industrial markets. Esmark, Inc. was formed in 1972, and became a publicly-owned holding company through a corporate reorganization with Swift and Company. Esmark operates several businesses through divisions and subsidiaries, such as the production and distribution of processed meats, poultry products, cheese, peanut butter and other foods, the production and distribution of fertilizers, mining and sale of phosphate rock, distribution of certain industrial chemicals, manufacturing of adhesives, coatings and other specialty chemicals, manufacturing and marketing of branded consumer packaged automotive products, high fidelity and industrial products and personal products through its International Playtex, Inc., Max Factor & Co., Halston Enterprises, Inc., and, at one time, the McCall Pattern Company subsidiaries. The McCall Pattern Company was sold on February 9, 1984. Esmark also owns Avis, Inc. and Avis Leasing Corporation and Somerset Importers, Ltd., which distributes in the United States an extensive line of distilled spirits. A sale of Somerset has been contemplated.

On May 3, 1984, Esmark announced it had received an offer from Kohlberg, Kravis, Roberts & Co. for $55 per share of common

stock for a total of $2.3 billion. This would have been the largest leveraged buyout at that time. On May 4, 1984, the Dow Jones Broad Tape reported that Esmark had accepted the offer and had entered a merger agreement with Kohlberg, Kravis, Roberts & Co. According to this agreement, Esmark had the right to terminate the agreement if its Board of Directors determined that an offer more favorable to Esmark's shareholders were commenced.

On May 21, 1984, Beatrice announced that its Board of Directors would consider a recommendation by management that Beatrice offer to acquire all of Esmark's common and preferred stock. On May 22, 1984, the Board approved the recommendation and began the offer on May 23, 1984. On May 23, 1984, LA Acquisition Corporation, a wholly-owned subsidiary of Beatrice organized for the purpose of acquiring Esmark, began a cash tender offer to purchase any and all outstanding shares of Esmark common and cumulative convertible series B preferred stock. On May 24, 1984, the price to be paid for the common stock and preferred stock was increased from $56 and $39.76 per share to $60 and $42.60, respectively. On June 13, 1984, Beatrice began purchasing the Esmark stock on June 14, 1984. The tender offer expired on June 20, 1984. Pursuant to the offer, Beatrice acquired approximately 91% of the outstanding common stock and approximately 72% of the outstanding preferred stock. Because Beatrice had prior holdings of Esmark stock, Beatrice then owned approximately 92% of Esmark common and 72% of the Esmark preferred stock. After which, Esmark merged into a subsidiary of

Beatrice to squeeze out any remaining shareholders, thereby causing Esmark to become an indirect wholly-owned subsidiary of Beatrice.

B. Financing of Acquisition

The total amount of funds required by Beatrice to purchase the Esmark stock pursuant to the offer was approximately $2.4 billion, plus about $236 million to pay for the remaining Esmark stock pursuant to the merger, and additional funds were needed for fees and expenses related to the offer and merger. The subsidiary making the acquisition received the funds from Beatrice through a capital contribution and/or loan from Beatrice. Beatrice obtained these funds from a six-month bridge loan that would be taken out by a new four-year revolving credit facility of $3.0 billion which Citibank, N.A. had agreed to arrange or directly by the revolving credit. Borrowings under the revolving credit arrangement bear interest (at Beatrice's option) of (i) 3/8 of 1% over a rate based on the London Interbank offered rate, (ii) 1/2 of 1% over a rate based on prevailing rates for Certificates of Deposit, or (iii) the floating base rate of Citibank, N.A. Borrowings under the revolving credit would be repayable in full on May 31, 1988. Upon four business day's notice, Beatrice would be able to reduce at any time, without penalty, all or a portion of the undrawn commitments in minimum amounts of $50 million. Beatrice would be able to prepay all or any portion of the borrowings without

penalty, subject to reimbursing each lender for any loss resulting from any prepayment prior to the end of an applicable interest period. The revolving credit provides for a commitment fee on the amount of the unused credit of 1/4 of 1% per annum and annual agent's fee of $35,000 and a one-time advisory fee of $1 million.

C. What Tax Code Provisions Were Utilized

The acquisition took the form of a taxable stock acquisition. We are unable to determine whether Beatrice will make a section 338 election for the acquisition of Esmark. In addition, we are unable to determine whether Beatrice or Esmark had net operating losses, "built-in losses," or unused tax credits at the time of the merger.

D. Amount of Profit Realized to the Acquired Company's Shareholders

Since Esmark was a publicly held company, we are unable to determine the amount of profit realized to the acquired company's shareholders.

6. General Motors Corp. - Electronic Data Systems Corp.

A. General Background of Acquisition

General Motors Corp. is a vertically-integrated business operating primarily in a single industry consisting of the manufacture, assembly, and sale of automobiles, trucks, and related parts and accessories classified as automotive products. Electronic Data Systems Corp.'s activities include the design of large scale data processing sytems and the operation of data centers and communication networks. EDS will be providing services of this kind to GM, which will substantially increase the scope of operations and revenues of EDS and will use a substantial portion of EDS's resources. It is estimated that in 1985, EDS will generage $2 billion in revenues from providing services to GM with additional revenues to be derived from international operations.

On October 13, 1984, GM acquired EDS and its subsidiaries for $2.5019 billion. The acquisition was consummated through an offer to exchange EDS common stock for either (a) $44 in cash or (b) $35.20 in cash plus 2/10's of a share of GM Class E common stock plus a nontransferable contingent promissory note issued by GM. Certain EDS stockholders elected to receive fluctuating rate GM notes due in 1985 in lieu of cash.

The Class E common stock has one-half vote per share and liquidation rights are based on voting rights with each share treated as 1/2 of a share of the $1-2/3 par value common stock. If GM should sell, liquidate, or otherwise dispose of EDS, GM must distribute $1-2/3 par value GM common stock in exchange for

the Class E stock in an amount equal to 120% of the value of the Class E stock. There were 11,371,268 shares of Class E common stock issued in the acquisition of EDS and an additional 2,270,160 of these shares issued in 1984 in conjunction with the EDS 1977 stock incentive plan.

The contingent notes, issued in acquiring a portion of the EDS stock, are payable in seven years in an amount equal to .2 times the excess of $125 over the market price of the Class E common stock at the maturity date of the note. Holders may tender their notes for prepayment at discounted amounts beginning five years after closing. If the market price of Class E common stock at the maturity date of the contingent notes were to equal the market price at December 31, 1984, $42.00 a share, the aggregate contingent considertion would be $940 million.

The results of EDS operations have been included in GM's statement of consolidated income since October 18, 1984. The effect of the acquisition on the 1984 consolidated net income of GM is a net charge of $26.1 million, consisting of the separate consolidated net income of EDS less the amortization of the intangible and other assets arising from the acquisition and the elimination of intercompany transactions. For the purpose of determining earnings per share and amounts available for dividends on common stocks, the amortization of these assets is charged against earnings attributable to $1-2/3 par value common stock. Earnings per share of $1-2/3 par value common stock would

have been reduced by $0.66 in 1984 and $0.83 in 1983 if the acquisition had been consummated at the beginning of those years.

B. Financing of Acquisition

GM financed the acquisition of EDS primarily through the issuance of the above described GM Class E common stock and contingent promissory notes. We are unable to determine the source of the cash funds used to acquire a portion of the EDS stock.

C. What Tax Code Provisions Were Utilized

The acquisition took the form of a taxable stock acquisition. We are unable to determine whether GM will make a section 338 election for the acquisition of EDS. In addition, we are unable to determine whether GM or EDS had net operating losses, "built-in losses," or unused tax credits at the time of the merger.

D. Amount of Profit Realized to the Acquired Company's Shareholders

Since EDS was a publicly held company, we are unable to determine the amount of profit realized to the acquired company's shareholders.

7. Broken Hill Proprietary Co. - Utah International Co.

A. General Background of Acquisition

Broken Hill Proprietary Co., Limited is an Australian industrial and natural resources company. Utah International, Inc., a mineral resources company whose principal product is coking coal mined in Australia, was a wholly-owned subsidiary of General Electric Company.

On April 2, 1984, Broken Hill purchased the stock of Utah International from General Electric for approximately $2.0 billion cash. In addition, General Electric retained ownership of certain property of Utah International valued at $387.5 million (a 15.5% interest in the new Queensland coal consortia which hold Utah International's Australian coal properties and an Australian coal mine).

B. Financing of Acquisition

Since Broken Hill is an Australian company, we cannot readily determine how the acquisition of Utah International was financed.

C. What Tax Code Provisions Were Utilized

The acquisition took the form of a taxable stock acquisition.

We are unable to determine whether Broken Hill will make a section 338 election for the acquisition of Utah International. In addition, we are unable to determine whether Utah International had net operating losses, "built-in losses," or unused tax credits at the time of the merger.

D. Amount of Profit Realized to the Acquired Company's Shareholders

Although we cannot readily determine the amount of profit realized to GE for tax purposes on the sale of Utah International, the GE financial statements indicate a $500 million gain on such transaction before taxes and after providing for future contractual obligations.

8. Champion International Corp. - St. Regis Corp.

A. General Background of Acquisition

Champion International is an integrated forest products company engaged in the manufacture, conversion and distribution of wood-based building materials, papers and paper packaging. St. Regis Corp. is also an integrated forest products company whose business segments are the manufacture and sale of kraft and recycled paper, printing papers, newsprint, construction, container and bag packaging products and oil and gas operations.

On August 1, 1984, Champion, acting through its wholly-owned subsidiary CHA Developments Corp., made a tender offer to purchase not less than 16,884,000 shares of common stock, $5 par value per share, of St. Regis Corp. at a price of $55.50 per share and all outstanding shares of $4.30 convertible exchangeable preferred stock, 1983 series, with a par value of $1.00 per share, of St. Regis Capital Corporation, a St. Regis subsidiary, at a price of $81.03 per share. By September 1984, CHA had acquired 17,958,871 shares of St. Regis common stock. That stock represented about 58.4% of the then outstanding common stock. Champion also acquired 1,363,787 shares of the preferred stock. The purchased preferred stock is convertible into 1,991,129 shares of St. Regis common stock which, together with the purchased common stock, represented approximately 61% of the common stock that would be outstanding after giving effect to teh conversion of the purchased preferred shares.

Effective on November 20, 1984, CHA merged with St. Regis. Each then outstanding share of St. Regis stock, not owned by Champion, a Champion subsidiary, or a dissenting St. Regis shareholder, was converted into the right to receive 2.85 shares of Champion $0.50 par value common stock. All St. Regis securities other than the common stock outstanding at the time of the merger will continue to be outstanding as securities of the surviving corporation, subject to their respective terms and provisions. The total value of the acquisition was approximately $1.8269 billion.

B. Financing of Acquisition

The purchase of the common and preferred stock of St. Regis Corp. were financed by Champion using $1.05 billion borrowed under a credit agreement with a group of commercial banks and the rest with internally generated funds.

C. What Tax Code Provisions Were Utilized

The acquisition took the form of a taxable stock acquisition. We are unable to determine whether Champion will make a section 338 election for the acquisition of St. Regis Corp. In addition, we are unable to determine whether Champion or St. Regis Corp. had net operating losses, "built-in losses," or unused tax credits at the time of the merger.

D. Amount of Profit Realized to the Acquired Company's Shareholders

Since St. Regis was a publicly held company, we are unable to determine the amount of profit realized to the acquired company's shareholders.

9. Phillips Petroleum Co. - Energy Operations of R.J. Reynolds Industries, Inc.

A. General Background of Acquisition

Phillips Petroleum Co. is an integrated company engaged in the production, transportation, refining and processing, distribution and marketing of crude oil, natural gas, refined petroleum products and petrochemicals including related products, and the production and marketing of synthetic fibers. R.J. Reynolds Industries, Inc. owned, directly or indirectly before the sale to Phillips, all of the outstanding stock of Aminoil Inc. and Geysers Geothermal Company. Aminoil is engaged in the exploration for and production of oil, gas, and related products, primarily in the United States. Aminoil has no refining or retail marketing operations. Geysers is engaged in the development and supply of geothermal steam. It is one of the major operators of the Geysers field, the largest commercially producing geothermal steam field in the world, which is located in California. Before August 1, 1984, Geyser's operartions were part of Aminoil.

On October 26, 1984, pursuant to a stock purchase agreement, Phillips Oil Company, a wholly-owned subsidiary of Phillips Petroleum Company, purchased all of the outstanding common stock of Aminoil and Geysers from R.J. Reynolds Industries, Inc. and its wholly-owned subsidiary, R.J. Reynolds Energy Corporation. The purchase price for such stock was approximately $1.3 billion. In addition, Phillips purchased from the Reynolds group the indebtedness of Aminoil and its subsidiaries to the Reynolds group for approximately $324 million, resulting in a total consideration of approximately $1.6 billion.

B. Financing of Acquisition

Phillips financed the acquisition with internally generated funds and with non-bank short-term borrowings. Subject to market and other conditions, Phillips may refinance all or a portion of the acquisition funds through one or more private or public debt oferings in or out of the U.S. or through loans under existing credit agreements and committed lines of credit.

A Phillips/Aminoil unaudited pro forma combined statement of incomes for the six months ended June 30, 1984 that reflects the later acquisition on October 26, 1984, shows an adjustment of an additional $41 million in interest and expense on indebtedness to reflect increased interest incurred to finance the Aminoil acquisition and estimated related tax liabilities, assuming a 10.2% interest rate on short-term borrowings of $1.6 billion, less Aminoil net interest incurred of $31 million on intercompany debt with Aminoil and affiliates. The same statement also shows a $38 million downward adjustment in the provision for income taxes to reflect lower federal and state income taxes attributable to increased interest expense ($20 million), lower interest income ($10 million) and increased depreciation, depletion and amortization expenses ($8 million), at an effective tax rate of 48%.

The combined income statement for the year ended December 31, 1983, has a similar adjustment of an additional $101 million in

interest and expense on indebtedness to reflect increased interest incurred to finance the Aminoil acquisition and estimated related tax liabilities, assuming a 9% interest rate on short-term borrowings of $1.6 billion, less Aminoil net interest incurred of $34 million on intercompany debt with Aminoil affiliates. The 1983 year combined income statement also has a downward adjustment of $81 million in its provision for income taxes to reflect lower federal and state income taxes attributable to increased interest expense ($48 million), lower interest income ($18 million) and increased depreciation, depletion and amortization expense ($15 million), at an effective tax rate of 48%

C. What Tax Code Provisions Were Utilized

The acquisitions took the form of taxable stock acquisitions. Although we do not know whether Phillips will make a section 338 election for the acquistiions, the Phillips and Aminoil unaudited pro forma combined balance sheet for June 30, 1984 that reflects the later acquisitions on October 26, 1984, has an upward adjustment of $243 million in accrued income and other taxes to reflect estimated liability for additional taxes due to anticipated election (under section 338) to treat the purchase of Aminoil stock as a purchase of assets for tax purposes and due to differences between Phillips and Aminoil's methods of calculating estimated taxes payable. We are unable to determine whether Phillips or Aminoil/Geyser had net operating losses, "built-in

losses," or unused tax credits at the time of the merger.

D. Amount of Profit Realized to the Acquired Company's Shareholders

Although we could not readily obtain information on the amount of profit realized for tax purposes to R.J. Reynolds Industries, Inc. or R.J. Reynolds Energy Corporation, the R.J. Reynolds Industries, Inc. financial statements for the year ended December 31, 1984 indicate a $275 million gain on the sale after tax expense of $162 million. Public documents also indicate that R.J. Reynolds may use all or a portion of the proceeds of sale will be used to repurchase up to 10,000,000 shares of its common stock, par value, at 73.50 per share, for which a tender offer was made on October 30, 1984. If all 10,000,000 shares are purchased, the cost to Reynolds, including all related fees and expenses, would be approximately $737,000,000. These funds will be provided from the proceeds of Reynold's sale of its energy operations to Phillips. Reynolds indicated that the offer was made based on its determination that long-term goals could be better advanced by placing a greater focus on its consumer products and services and by divesting its principal nonconsumer businesses. The offer affords the sellers of the Reynolds stock to realize a premium over market price without the usual transaction costs associated with a market sale.

10. Manufacturers Hanover Corp. - C.I.T. Financial Corp.

A. General Background of Acquisition

Manufacturers Hanover Corp. is a bank holding company. C.I.T. Financial Corp. was a wholly-owned subsidiary of RCA Corporation. CIT, directly or through its subsidiaries, engages in industrial financing and leasing, consumer financing, factoring and commercial financing.

Effective May 1, 1984, Manufacturers Hanover acquired C.I.T. Financial Corporation and its subsidiaries for $1.51 billion in cash and securities pursuant to an agreement for sale signed between Manufacturers Hanover and RCA Corporation on October 31, 1983. The acquisition did not include the insurance subsidiaries of CIT, one of which was sold separately to another buyer and the second of which is up for sale.

Manufcturers Hanover's payments to RCA totaled $1.51 billion paid as follows: (1) $460 million in cash, (2) $150 million liquidation value of Manufacturers Hanover adjustable rate perpetual preferred stock, (3) $100 million liquidation value of Manufacturers Hanover adjustable rate convertible perpetual preferred stock, and $800 million of eight-year senior installment notes of Manufacturers Hanover.

The $150 million adjustable rate perpetual preferred stock has a 10 per cent annual dividend rate for the first two years. Thereafter, the dividend will be adjusted quarterly to 2-5/8

percentage points below the highest of the 90-day treasury bill rate, the 10-year constant maturity treasury rate and the 20-year constant maturity treasury rate, with a 6 per cent minimum and 12 per cent maximum rate. The $100 million adjustable rate convertible perpetual preferred stock is convertible into Manufacturers Hanover common stock at a conversion price of $52.00 per share and has an annual dividend rate of 12 per cent for the first five years. Thereafter, the dividend will be adjusted quarterly to 4-1/4 percentage points below the highest of the formula rates applicable to the adjustable rate preferred stock with the same minimum and maximum rates. Both issues of preferred stock are non-callable for five years. The $800 million eight-year senior installment notes of Manufacturers Hanover bear interest at a 12 per cent annual rate and have a weighted average life of five years.

B. Financing of Acquisition

In addition to the issuance of the above preferred stock and installment notes, the cash used in the transaction was funded by the previous sale of $257.5 million of long-term debt. The proceeds of this sale were maintained on deposit with Manufacturers Hanover Trust Company as well as $202.5 million received from the issuance of 5 million shares of new common stock in early 1984.

C. What Tax Code Provisions Were Utilized

The acquisition took the form of a taxable stock acquisition. We are uanble to determine whether Manufacturers Hanover will make a section 338 election for the acquisition of CIT. In addition, we are unable to determine whether Manufacturers Hanover or CIT had net operating losses, "built-in losses," or unused tax credits at the time of the merger.

D. Amount of Profit Realized to the Acquired Company's Shareholders

We could not readily obtain information on the amount of profit realized to RCA on the sale of CIT since the financial statements of RCA indicate that such gain was immaterial.

Not Reviewed by the Office of Management and Budget
Due to Time Constraints

For Release Upon Delivery
Expected at 9:30 A.M., E.S.T.
April 22, 1985

STATEMENT OF
RONALD A. PEARLMAN
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to present the views of the Treasury Department on three bills (S. 476, S. 420, and S. 632) relating to corporate acquisitions. These bills appear to be prompted by the recent surge in merger activity generally, but are particularly directed at hostile merger activity. The bills would substantially penalize, if not render economically impossible, mergers and acquisitions that are considered "hostile."

We do not believe that Congress should enact special tax provisions aimed only at hostile as opposed to friendly acquisitions. Indeed, we do not believe that Congress should amend the tax laws for the purpose of discouraging mergers and acquisition activity generally.

We do not know all of the economic and other reasons behind the recent flurry of activity. We doubt, however, that the tax laws are the driving force, but rather suspect that other market forces precipitate these transactions; forces that reallocate resources to higher valued uses, promote economies of scale,

increase shareholders' return on investment, replace inefficient management, and free up capital for new investment opportunities. Only those persons responsible for the merger activity know for certain the forces that drive their decisions.

The bills that are the subject of today's hearing would discourage hostile takeovers by disallowing interest deductions with respect to certain indebtedness and mandating a section 338 election for certain stock purchases. In addition, the bills would discourage attempted takeovers by imposing an excise tax on certain profits realized by persons who take substantial investment positions in companies that are the subject of an attempted takeover. These profits have recently been referred to as greenmail profits. The bills also would clarify that under current law no deduction is available with respect to any greenmail payments.

The Treasury Department opposes these bills. As a matter of tax policy, we do not believe hostile acquisitions should be treated differently under the tax laws than friendly acquisitions, nor do we believe that a clear distinction can be drawn. Thus, we believe that interest deductions and section 338 elections should be equally available for hostile and friendly acquisitions. Further, we do not believe that certain gains from sales or exchanges of stock, labeled greenmail profits, should be subject to an excise tax. Finally, while greenmail payments are not deductible under current law, we would not be opposed to a statutory confirmation of this point.

Hostile Versus Friendly Acquisitions

All of the bills that are the subject of today's hearing would limit interest deductions, and both S. 632 and S. 420 would mandate section 338 elections, for all hostile acquisitions. Hostile acquisitions are defined in two different ways, however. S. 476 defines the term "hostile acquisition" generally as an acquisition of corporate property or stock by persons who have acquired a 20 percent or greater interest in the target corporation within the preceding year, if the transaction, before consummation, is not formally approved by a majority (consisting of at least two members) of the independent members of the board of directors of the target corporation. No member of the board would be treated as independent if such member is an officer or employee of the corporation or was nominated by the persons making the acquisition.

Both S. 632 and S. 420, framed more broadly than S. 476, apply to acquisitions by any persons, if the acquisition is pursuant to a "hostile offer." The term "hostile offer" turns on the same factor as S. 476 -- disapproval by a majority (consisting of at least two members) of the independent members of the board of directors of the target corporation. The

definition of an independent director is more restrictive under S. 632 and S. 420 than S. 476, as it not only excludes from the definition a person that is an officer or employee of the target corporation, but also any person that has substantial financial or commercial ties to that corporation, except for ownership of stock.

We do not believe the tax consequences of corporate acquisitions should turn on whether a corporation's independent directors approve or disapprove of the acquisition. Moreover, the effect of these bills would be to bring new and extreme pressure to bear on the decision making processes of independent directors. Because of the harsh tax consequences resulting from characterization of an acquisition as hostile, independent directors would in effect have a veto over corporate acquisition decisions. On the other hand, there may be substantial enough pressures on the independent directors that would, under certain circumstances, tend to make them vote for, rather than against, a proposed acquisition. For only by their favorable votes could the sanctions imposed by these bills be avoided. Such pressures would seem to undermine the very rationale for independent directors.

Further, many closely held corporations do not have independent members on their boards of directors. In such cases, the tax penalties could not come into play no matter how vigorously a takeover is resisted. The bills do not suggest any rationale for this arbitrary distinction. If these tax penalty provisions were enacted, however, companies would have an incentive not to have independent directors. We doubt that the sponsors of the bills intend such a result.

We believe very strongly that the market place (i.e., shareholders rather than independent directors) should determine whether a proposed acquisition is economically beneficial. The tax laws should not bias this decision towards friendly or against hostile acquisitions, as a hostile acquisition may turn out to be an economically beneficiary acquisition. Only a free market can make the optimal economic decision.

Disallowance of Interest Deductions on Certain Hostile Acquisitions

All of the bills before the Subcommittee limit the deductibility of interest incurred in connection with "hostile" takeovers. The genesis of these bills apparently stems from the publicity received by a number of recent acquisitions financed by the use of so-called junk bonds (i.e., high risk, high yield subordinated debt) and a concern that the current tax treatment of interest may encourage mergers, especially hostile acquisitions. The basic structure of our current income tax system may encourage corporations to utilize debt rather than

equity in financing operations or acquisitions because of the more favorable tax treatment of interest compared to dividends and the arbitrage potential from debt financing.

S. 476 would disallow a deduction for any interest paid or accrued during the taxable year with respect to "hostile acquisition indebtedness." Hostile acquisition indebtedness is defined as any "junior obligation" issued after February 18, 1985, in connection with a hostile acquisition. A "junior obligation" is any obligation evidenced by a bond, debenture, note or certificate, or other evidence of indebtedness issued by any person which, upon issuance, bears any one or more of the following characteristics: (1) the indebtedness is expressly subordinated to the payment of any substantial amount of unsecured indebtedness of the issuer or the corporation that is the target of the hostile acquisition, (2) the indebtedness is issued by a person whose assets are (or following the hostile acquisition would be) comprised predominantly of the stock of the target corporation, cash, and cash equivalents, or (3) the indebtedness bears a rating from any nationally recognized rating agency which is at least two ratings inferior to the rating from such agency in respect of any other substantial class of indebtedness of the issuer or the target corporation. S. 476 is effective with respect to interest paid or accrued with respect to obligations issued after February 18, 1985.

S. 632 differs slightly from S. 476 in that it disallows a deduction for any interest paid or accrued on indebtedness incurred or continued to acquire (or carry) stock or assets acquired pursuant to a "hostile offer." The definition of "hostile offer" differs only slightly from the definition of "hostile acquisition" in S. 476 as discussed above. S. 632 is effective with respect to indebtedness incurred or continued to acquire (or carry) stock acquired after March 6, 1985. For assets acquired pursuant to a "hostile offer," S. 632 fails to provide a specific effective date for its application to indebtedness incurred or continued to acquire (or carry) such assets.

S. 420 is identical to S. 632 with respect to the disallowance of interest deductions, except that it does not apply to indebtedness incurred or continued to acquire (or carry) assets; it is limited to acquisitions of stock. S. 420 is effective with respect to indebtedness incurred or continued to acquire (or carry) stock which is acquired after February 6, 1985.

Our current income tax system generally treats corporations as taxpaying entities separate from their shareholders. A corporation separately computes and reports its taxable income,

and in making this calculation it is not entitled to a deduction for dividends paid to shareholders. Moreover, these dividends are taxed to individual shareholders as ordinary income (except for a $100 per year exclusion). Consequently, corporate taxable income paid as dividends to individual shareholders generally bears two taxes, the corporate income tax and the individual income tax.

The double taxation of corporate earnings that are distributed as dividends to shareholders affects dividend distribution policies in ways that may encourage merger activity. In particular, corporations, especially those with shareholders in relatively high income tax brackets, are encouraged to retain earnings in order to allow the shareholders to defer imposition of the second tax.*/ This pressure to accumulate corporate earnings not only interferes with ordinary market incentives to place funds in the hands of the most efficient users, but also stimulates corporate acquisitions in at least two ways.

First, corporations that accumulate cash funds in excess of their needs for working capital must reinvest those funds; acquiring the stock or assets of other corporations is an investment alternative that must be considered by any corporation with excess funds to invest. Second, a corporation with large amounts of funds invested in nonoperating assets may itself become an attractive target, because the market may not immediately reflect the value of those nonoperating assets (which may not generate financial reported earnings commensurate with their values). Because of this potential undervaluation of the target's nonoperating assets, a potential acquiring corporation may view the nonoperating asset as cheap funds available to finance the acquisition of the underlying business operations of the target. The mitigation or elimination of the double tax on corporate dividends, through any form of integration of the corporate and individual income taxes, would reduce or eliminate these effects.

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*/ Indeed, in some cases the shareholder-level tax can be permanently avoided if the retained earnings are distributed in liquidation following the death of the shareholder, which occasions a tax-free increase in the stock's basis to its fair market value. However, if the corporation is formed or availed of for the purpose of avoiding the second shareholder-level tax by permitting earnings and profits to accumulate instead of being distributed, there is imposed on the corporation a penalty accumulated earnings tax.

In contrast to the taxation of corporate earnings distributed as dividends, corporate income distributed to creditors as interest is deductible by the corporation and thus taxed only once, to the creditors. The disparate tax treatment of debt and equity in the corporate sector distorts decisions regarding a corporation's capitalization, making corporations more vulnerable to takeover during economic downturns, and also may encourage leveraged buyouts, because interest payments on the debt incurred in such a transaction offset income earned by the target corporation.

Since interest payments on debt financing are deductible and dividends paid on equity are not, corporations are encouraged by the tax law to utilize debt rather than equity to finance their ongoing operations. This may result in an increased debt-to-equity ratio that increases the risk of bankruptcy and vulnerability to downturns in the business cycle; and any corporation that is temporarily crippled by an economic downturn becomes a likely takeover candidate.

The deductibility of interest incurred in connection with debt-financed acquisitions also encourages acquisitions to the extent that our tax system does not take account of inflation properly. Nominal interest rates typically include an inflation component which compensates the lender for the anticipated future reduction in the real value of a fixed dollar amount debt obligation and acts as an offsetting charge to the borrower for the inflationary reduction in the value of the principal amount of the borrowing. Where borrowed funds are invested in assets that also increase in value by virtue of inflation, the tax law permits a current deduction for interest expense but no realization of the increase in value of the asset until its sale or disposition. In such cases, the interest deduction can be used to offset income that otherwise would be taxed currently.

The use of installment debt in acquisitions also leads to significant mismatching of the gain that is deferred by the seller and the allowance to the purchaser of depreciation, amortization, or depletion deductions determined by reference to asset values that have been stepped-up to fair market value as a result of the acquisition. This asymmetrical treatment of a sale, under which the buyer is treated as acquiring full ownership of the asset while the seller is treated as making only partial sales each year over the term of the contract may create a tax bias for installment debt-financed acquisitions. In a taxable corporate acquisition (an asset acquisition or a stock acquisition with a section 338 election), this mismatching is reduced to some extent if the target corporation's assets are subject to recapture tax since the recapture income is recognized immediately. The asymmetrical treatment arising from installment sales debt is a problem that should concern this Subcommittee, but the problem exists in every installment sale of a depreciable asset and is by no means unique to corporate acquisitions.

One of the bills, S. 476, would deny deductions for interest paid on high yield, subordinated bonds used to finance hostile acquisitions. The concern generating the bill may have been that a number of these bonds, referred to as "junk bonds," have been used in connection with recent highly leveraged acquisitions. There is a substantial argument that some of these bonds would be more appropriately classified as equity rather than debt. Although there are significant differences in the tax treatment of debt versus equity, it is extremely difficult to develop general rules to differentiate a debt interest from an equity interest. Section 385 lists certain factors that are to be taken into account in distinguishing debt from equity interests. Although section 385 was enacted in 1969, to date no satisfactory general rules have been developed. The Internal Revenue Service has administered this area, and will continue to differentiate instruments including junk bonds, on a case by case basis. S. 476 does not consider any facts and circumstances other than those enumerated in its definition of junior obligation and, therefore, may inappropriately characterize some junior obligations as equity.

Two of the bills before the Subcommittee, S. 632 and S. 420, address the disparate treatment of debt and equity and the potential arbitrage from debt financing by limiting interest deductions on all indebtedness incurred or continued in connection with hostile acquisitions. The tax arbitrage from debt financing generally is available, however, for all debt-financed corporate assets, not just those acquired in a corporate merger or acquisition. The only special limitation on the deductibility of interest on debt incurred in acquisitions is found in section 279 which applies only under very limited circumstances. Although it may be appropriate to give consideration to revising the general rules regarding the deductibility of interest, we see no justification for a further limitation on the deductibility of interest expense that is aimed specifically at debt incurred in connection with hostile acquisitions. Any tax advantage to utilizing debt in a corporate acquisition is available both to hostile as well as friendly acquisitions. We believe that any remedy to limit the advantage to utilizing debt rather than equity to finance corporate acquisitions should be done in a neutral manner.

Mandatory Section 338 Election in the Case of Hostile Stock Purchases

Two of the bills before the Subcommittee mandate that in a hostile stock acquisition, the acquiring company is deemed to have made a section 338 election for the target corporation, and that certain other provisions of the tax law that generally apply when a section 338 election is made, do not apply.

Generally, as described above, a corporation is subject to tax on the profits derived from its operations and its shareholders are subject to a second level of tax on the distributions of those profits as dividends. In a liquidating sale of assets or sale of stock subject to a a section 338 election, the acquiring company obtains the benefits of a step-up in basis of the acquired assets with only a partial corporate level tax; recapture and tax benefit items are taxed, but other potential gains are not. This result stems from the rule attributed to General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), that is now codified in sections 311(a), 336 and 337. Under those provisions, a corporation does not recognize gain (other than recapture and tax benefit items) on certain distributions, including liquidating distributions, made to its shareholders.

The General Utilities rule applies when a section 338 election is made. The election is available generally whenever one corporation purchases at least 80 percent of the stock of a target corporation over a 12-month period. If such election is made, the basis of the assets of the target corporation is adjusted in a manner similar to the adjustments that would occur if the target corporation had sold all of its assets to the acquiring corporation in connection with a plan for complete liquidation. The target corporation does not recognize gain (or loss) on such deemed sale (except for recapture and tax benefit items). The price at which the assets are deemed sold by the target corporation and purchased by the new corporation is generally the purchasing corporation's basis in the target's stock at the acquisition date.*/

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*/ Section 338(a)(1) provides that the target corporation is deemed to sell its assets at their fair market value on the acquisition date. Alternatively, in the case of a bargain stock purchase, an election may be made under section 338(h)(11) to determine the aggregate deemed sale price on the basis of a formula that takes into account the price paid for the target corporation's stock during the acquisition period (grossed-up to 100 percent) plus liabilities (including taxes on recapture and other tax benefit items generated in the deemed sale) and other relevant items. Section 338(b) provides that the new corporation is deemed to purchase the target corporation's assets at an aggregate price equal to the grossed-up basis of recently purchased stock plus the basis of nonrecently purchased stock (subject to an election under section 338(b)(3) to step-up the basis of such nonrecently purchased stock) plus liabilities (including taxes on recapture and other tax benefit items generated in the deemed sale) and other relevant items.

There is generally no requirement that a purchasing corporation make a section 338 election for the target corporation. If no section 338 election is made for the target, no gain or loss is recognized with respect to target's assets and its corporate tax attributes are preserved, subject to certain limitations.

S. 632 provides that in the case of any hostile qualified stock purchase, the purchasing corporation will be treated as having made a section 338 election with respect to such purchase. In addition, all gain, not just recapture and tax benefit items, will be recognized on the deemed sale of assets. Moreover, the basis of the target's assets deemed purchased will be reduced by the amount of tax imposed on the target corporation as a result of the deemed sale. S. 632 is effective for hostile qualified stock purchases after March 6, 1985.

S. 420 is identical to S. 632, except that there is no requirement that the basis of target's assets deemed purchased be reduced by the amount of the tax imposed on the target corporation on the deemed sale. S. 420 is effective for hostile qualified stock purchases after February 6, 1985.

The availability of the section 338 election does not create any significant tax incentives for either hostile or friendly acquisitions. The provision was intended to facilitate mergers and acquisitions by permitting the acquiring corporation to replicate the tax consequences that would follow from an asset acquisition without requiring an actual sale and transfer of those assets. In many cases, however, the tax consequences of an actual asset acquisition or a deemed asset acquisition under section 338 will be adverse. Acquiring corporations have always been able to avoid such consequences by acquiring the stock of the target corporation and forgoing any adjustment in the basis of the assets of the target company. There are no tax policy considerations that suggest this latter alternative should be foreclosed to hostile takeovers. If a mandatory section 338 election were imposed, there would be a substantial bias in the tax law against hostile acquisitions of certain companies, especially those with large recapture and tax benefit items. We do not believe there is a sound tax policy reason for imposing that bias.

Similarly, we do not believe that there is any sound basis for imposing the additional tax penalties on hostile stock acquisitions that are proposed by S. 420 and S. 632. Whether all gains, not just recapture and tax benefit items, should be recognized on an actual liquidating sale of corporate assets or a deemed sale pursuant to a section 338 election, is not an issue that should turn on whether the acquisition is hostile or friendly. Finally, the reduction in basis for the tax liability generated on the deemed sale in a mandatory section 338 election

prescribed by S. 632 is contrary to fundamental tax concepts, and amounts to an awkward and ill-conceived penalty on hostile acquisitions.

Excise Tax on Greenmail Profits and Deductibility of Greenmail Payments

Although the bills, as discussed above, generally attempt to distinguish between hostile and friendly acquisitions, they also deal with so-called "greenmail" paid and received in either hostile or friendly situations. As the term is commonly used, greenmail refers to a payment made by a corporation to a particular shareholder, often referred to as a "raider," who has purchased a substantial amount of the corporation's stock as part of a plan to acquire the corporation.*/ The offer to purchase the raider's stock is usually not made to all shareholders and is thus known as "greenmail." In exchange for the payment, the raider sells his stock to the target corporation and agrees to refrain from further attempts to acquire the corporation (a "standstill agreement"). Although the payment is made in exchange for the stock surrendered by the raider, it also may include reimbursement for expenses incurred by the raider in the takeover attempt.

In an attempt to eliminate greenmail payments, S. 476 and S. 420 impose a nondeductible 50 percent excise tax on any person who realizes "greenmail profits." Although greenmail, as described generally above, commonly refers to payments made by a corporation to an unwanted shareholder, both bills would sweep more broadly. In particular, greenmail profits are defined under

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*/ Because shares of a publicly traded target corporation are readily available for purchase on a stock exchange and the raider is generally not required to disclose his intentions until he has acquired five percent of the corporation's stock, the existence and identity of a potential raider may not be known by the target corporation until the raider has acquired the threshold five percent. Under the Williams Act, owners of five percent or more of a corporation's stock are required publicly to disclose the amount of their ownership and their plans with respect to the corporation. Accordingly, neither the target nor the market may be aware of a takeover attempt until the raider has acquired a substantial amount of stock.

S. 420 to include any gain realized by a "4-percent shareholder"*/ on the sale or exchange of any stock in the corporation if (1) the shareholder held such stock for a period of less than two years, and (2) there was a public tender offer for stock in the corporation at any time during the two-year period ending on the date of such sale or exchange. Under S. 476, greenmail profits also arise from a sale or exchange if, at any time during the two-year period, any 4-percent shareholder submitted a written proposal to such corporation which suggests or sets forth a plan involving a public tender offer, regardless of whether a public tender offer is actually made.**/

The tax would not apply, however, to a gain realized by any person on the sale or exchange of stock in any corporation if, throughout the 12-month period ending on the date of such sale or exchange, such person had been an officer, director, or employee of the corporation or a 4-percent shareholder. Under the bills, therefore, the 50 percent excise tax would generally apply to gains realized by relatively large, short-term shareholders. Both bills would be effective for sales and exchanges made after February 6, 1985, except for sales or exchanges made pursuant to a written agreement in existence on February 5, 1985.

The 50 percent excise tax proposed by both bills is deficient in several respects. First, the Treasury Department does not believe that any valid tax policy is served by subjecting greenmail profits to an additional tax. If greenmail payments are determined to be contrary to the public interest, they should be deterred directly, rather than through use of the tax laws. For example, state corporate laws could be amended to prohibit greenmail payments. Moreover, if such payments are judged by shareholders to be generally unacceptable, direct action may be taken. In particular, as many corporations have done, corporate charters may be amended to proscribe such payments.

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*/ Under both bills, a "4-percent shareholder" means any person who owns stock possessing four percent or more of the total combined voting power of all classes of stock entitled to vote. For purposes of determining whether a person is a 4-percent shareholder, stock owned both directly and indirectly (through the application of section 318) is considered.

**/ The term public tender offer is defined under both bills to mean any offer to purchase (or otherwise acquire) stock if the offer is required to be filed or registered with any Federal or state agency regulating securities.

In addition to the fact that the tax law is an inappropriate tool to deter greenmail payments, the technique adopted by the bills seems overly harsh and imprecise. Under current law, gains realized on a sale or exchange of stock are generally treated as capital gains. Assuming the shareholder had no capital losses, gains from the sale or exchange of stock held for six months or less are taxed as ordinary income at a maximum rate of 50 percent, while gains from stock held for more than six months receive preferential tax treatment. In particular, individuals and other noncorporate taxpayers may exclude 60 percent of the gain from income, and corporations are subject to a maximum rate of 28 percent on such gain. Under the bills, therefore, an individual shareholder who owned four percent of a corporation's stock for six months or less at the time of the sale could be subject to a 100 percent tax on any gain, a 50 percent ordinary income tax and the 50 percent excise tax.*/ The Treasury Department does not believe that such a confiscatory rate of tax is appropriate under any circumstances.

Moreover, we believe that a 4-percent shareholder, like any other investor, is subject to the vagaries of the market and should be taxed as any other investor. We perceive no tax policy rationale for taxing a larger shareholder at a higher rate than a smaller shareholder on an identical economic gain.

In addition, although the bills are styled as imposing an excise tax on "greenmail," their reach is much broader. In particular, the excise tax would apply to any investor who purchased more than four percent of a corporation's stock, regardless of whether the shareholder purchased the stock with an intent to acquire the entire corporation. Such large shareholders could include a variety of institutional investors, such as pension plans, college and museum endowment funds, and large private investors. While such investors normally hold stock for periods of longer than one year, and would thus be excluded from the excise tax under both bills, situations would arise in which such investors, who had recently purchased stock, would want to sell. These situations would include a variety of circumstances under which nstitutions may be forced to liquidate an investment for external reasons, as well as the simple desire

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*/ Even if the shareholder had held the stock at the time of the sale for more than six months, but less than one year, the gain could be taxed at 70 percent. Corporate shareholders, depending on the length of their holding periods, would be subject to maximum effective rate of either 96 percent or 78 percent.

to take advantage of appreciation caused by an actual or anticipated public tender offer. We do not believe that such investors should be subject to the punitive tax proposed by the bills.*/ While such large shareholders could avoid application of the excise tax by holding their stock for more than one year, such potentially noneconomic behavior should not be required by the tax laws.**/

The final class of persons who might be subject to the greenmail excise tax are so-called "arbitrageurs." Such investors often take relatively large positions in a corporation's stock in anticipation of a tender offer at a price in excess of the prevailing market price. While such an investor may seek to benefit directly from a raider's attempt to acquire control of a corporation, we do not believe that any tax policy justifies taxing such person at exorbitant rates.

In summary, the Treasury Department believes that S. 420 and S. 476 represent an imprecise and overly harsh response to a perceived problem that may not be a problem at all. In any event, the solution does not reside in the tax laws. Consequently, we oppose the excise tax provisions in both bills.

Focusing narrowly on the tax treatment of "greenmail" by the corporation, S. 632 provides expressly for the disallowance of a deduction for any "greenmail payment." A greenmail payment is defined by S. 632 as any payment made by a corporation in redemption of its stock from a 4-percent shareholder if (1) such shareholder held such stock for a period of less than two years, and (2) there was a public tender offer for stock in the corporation at any time during the two-year period ending on the date of such sale or exchange. A greenmail payment also would include any payment to a 4-percent shareholder or other person for any expenses paid or incurred in connection with a redemption or public tender offer. Like S. 476 and S. 420, the term 4-percent shareholder does not include a person who holds at least four percent of the total voting power of the corporation's stock throughout the one-year period preceding the redemption or who was an officer, director, or employee of the corporation throughout that period. There is no specific effective date for these provisions in S. 632.

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*/ Even if institutions that are exempt from the income tax also were exempted from the excise tax, it would still fall inappropriately on some large taxable investors.

**/ The one year exception in the bill would permit a raider to avoid the excise tax simply by holding a four percent interest for one year. While business and other factors might preclude the use of such a tactic, the exception will diminish the effectiveness of the provision.

Under current law, the repurchase of stock by a corporation, regardless of the amount of stock owned by the shareholder from whom the stock is redeemed, is a capital transaction that can not give rise to a deductible loss and payments made by a corporation in such a transaction are not deductible.*/ Consequently, the Treasury Department believes that the provision of S. 632 denying a deduction for redemption payments made to a 4-percent shareholder under certain circumstances represents a limited restatement of current law principles.

S. 632, however, contains an exception for redemption payments made to a shareholder who, throughout the one-year period preceding the redemption, was an officer, director, or employee of the corporation or a 4-percent shareholder. Moreover, S. 632 does not apply to redemption payments made to a shareholder who owns stock possessing less than four percent of the voting power of all the corporation's stock. Because redemption payments are not generally deductible under existing law regardless of the size or identity of the redeemed shareholder, we believe that S. 632 is defective to the extent that it suggests that redemption payments made to such shareholders could be deducted by a corporation.

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*/ The courts have held repeatedly that an amount paid by a corporation to redeem its stock is a nondeductible capital transaction. See H. and G. Industries, Inc. v. Commissioner, 495 F.2d 653 (3d Cir. 1974); Jim Walter Corp. v. United States, 498 F.2d 638 (5th Cir. 1974); Richmond, Fredericksburg and Potomac Railroad Co. v. Commissioner, 528 F.2d 917 (4th Cir. 1975); Markham & Brown, Inc. v. United States, 648 F.2d 1043 (5th Cir. 1981); Harder Services, Inc. v. Commissioner, 67 T.C. 584 (1976); Proskauer v. Commissioner, 46 T.C.M. 679 (1983). In one isolated case, Five Star Manufacturing Co. v. Commissioner, 355 F.2d 724 (5th Cir. 1966), a court held that an amount paid by a corporation to repurchase its own stock was a deductible business expense in light of a showing that liquidation of the corporation was imminent in the absence of the redemption, no value would have been realized by the shareholders upon such a liquidation, and the redemption represented the only chance for the corporation's survival. Regardless of whether Five Star Manufacturing was correctly decided, it has since been strictly limited to its unusual facts, see, e.g., Jim Walter Corp, supra, and its continuing vitality, even on those unusual facts, is unclear, see Woodward v. Commissioner, 397 U.S. 572 (1970).

Despite the clarity of existing law and repeated losses in litigation, some corporations engaged in takeover fights have apparently taken the position that redemption payments may be deductible for Federal income tax purposes on the theory that they are made to "save" the corporation. We believe that treating redemption payments as deductible expenses under the circumstances contemplated by S. 632 is inconsistent with existing law. Nevertheless, we would not object to an express statutory confirmation that existing law bars the deductibility of redemption payments. If such an amendment were adopted, however, it should expressly deny deductibility for all redemption payments, regardless of the size or status of the shareholder, and the accompanying legislative history should state clearly that the amendment does not create any inference that the Congress believes such payments are deductible under existing law.

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This concludes my prepared remarks. I would be happy to respond to your questions.

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STATEMENT OF
RONALD A. PEARLMAN
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
AND THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE
HOUSE WAYS AND MEANS COMMITTEE

Mr. Chairmen and Members of the Subcommittees:

I am pleased to appear before you today to discuss some of the more significant Federal income tax aspects of corporate acquisitions. The recent surge in merger activity and the publicity surrounding recent acquisitions (and attempted takeovers) of large, publicly held corporations has renewed concern that our tax laws inappropriately encourage these transactions. We do not know all of the economic and other reasons behind the recent flurry of activity. However, we doubt that tax considerations are the driving force. We suspect that other market forces precipitate these transactions; forces that reallocate resources to higher valued uses, promote economies of scale, increase shareholders' return on investment, replace inefficient management, and free up capital for new investment opportunities. Only those persons responsible for the merger activity know for certain the forces that drive their decisions; I will not today speculate on their decision making process, instead I will concentrate on the principal tax aspects of mergers and acquisitions and defer to the expertise of others on the effect of these corporate acquisitions on the economy as a whole.

While it is doubtful that our tax laws are primarily responsible for the recent merger upswing, they play an important role in these transactions, just as they do in virtually every business transaction corporations conduct. The subject of the hearing today concerns those aspects of our current tax laws that exert the greatest influence on merger activity. The first part of my testimony summarizes the different types of corporate acquisitions and describes the divergent tax consequences that may be obtained. The second part of my testimony discusses certain structural features of our tax system that appear to encourage corporate acquisitions and takeovers. The third part of my testimony describes recent trends in merger activity that raise significant tax policy issues. Included among these are the use of ESOPs in leveraged buyouts, the use of asset reversions from overfunded defined benefit plans to finance mergers and acquisitions and the carryover of tax attributes in mergers and acquisitions of thrift institutions. Finally, I will discuss certain legislative proposals that are inspired by the current wave of mergers and acquisitions.

I. Taxing Corporate Acquisitions - An Overview

In general, for tax purposes, corporate acquisitions are categorized into two basic forms -- taxable and tax-free. While this categorization vastly oversimplifies how the tax law applies to these transactions, it is useful in analyzing the important tax policy questions in this area to think of the transactions as coming within one of these two categories; for it is this categorization that will trigger the most significant tax consequences. This first part of my testimony summarizes the types of mergers and acquisitions that come within each category and their principal tax consequences.

A. Tax-Free Acquisitions

The distinctive characteristic of a wholly tax-free acquisition is that no gain or loss is recognized by the target corporation or its shareholders. The target shareholders are permitted to roll over their investment position in the target corporation for an investment position in the acquiring corporation without paying current tax. This tax-free rollover, however, is generally available only to the extent the target shareholders receive stock of the acquiring corporation or certain related corporations. Other consideration received by the target shareholders is taxable either as dividend income or capital gain, depending upon the application of a complicated set of judicial and statutory rules that strive to make this ever difficult distinction.

A tax-free acquisition generally will not generate taxable income to the target corporation, even if that corporation has appreciated assets. The corollary of this tax-free treatment is that the target corporation's historic tax basis for its assets "carry over" to the acquiring corporation and are not "stepped-up" (or down) to fair market value. Moreover, with certain limitations discussed below, tax attributes of the target corporation, such as net operating losses and unused credits and accumulated earnings and profits, will also carry over to the acquiring corporation.

To qualify as a tax-free acquisition, the transaction generally must qualify as a "reorganization" as defined in section 368 of the Code.*/ Although the statutory definition and judicial interpretations place significant constraints on how a reorganization can be structured, significant flexibility does exist. Thus, a tax-free acquisition can take the form of a direct acquisition of the target corporation's assets, the acquisition of the target corporation's stock, or a combination of the target and the acquiring corporation pursuant to statutory merger or consolidation.

B. Taxable Acquisitions

The principal characteristic of a taxable acquisition that sets it apart from a tax-free acquisition is that the seller in a taxable acquisition cannot receive a tax-free rollover of his investment. The seller in a taxable acquisition can be either the target corporation (a taxable asset acquisition) or the target shareholders (a taxable stock acquisition). The collateral consequences of a taxable asset acquisition and a taxable stock acquisition differ in so many respects that each will be discussed separately.

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*/ A "reorganization" is defined in section 368(a) as including four basic types of acquisitions: statutory mergers (type "A" reorganizations), stock-for-stock exchanges (type "B" reorganizations), asset-for-stock exchanges (type "C" reorganizations), and bankruptcy reorganizations (type "G" reorganizations). Tax-free acquisitions can also be effected through compliance with section 351. In addition to satisfying the statutory definition, a reorganization must meet certain other regulatory and common law tests (such as the "continuity of interest" and "continuity of business enterprise" tests) in order to qualify as a reorganization. Although there is some uncertainty regarding application of these statutory and judicial tests to particular fact patterns, there is a substantial body of case law and Internal Revenue Service rulings and past history that provide guidance to taxpayers.

1. Taxable Asset Acquisitions

In a taxable asset acquisition, gain or loss is recognized by the target corporation, unless, as discussed below, the target corporation is completely liquidated within a statutorily prescribed time. The sale may be reported on the installment method, however, in which case any capital gain is deferred and reported as the installment payments are received. In any case, the tax basis of the assets acquired are adjusted to reflect the purchase price paid for those assets. In a taxable asset acquisition, the acquiring corporation does not succeed to any of the target corporation's tax attributes, such as net operating losses and unused credits and accumulated earnings and profits. These tax attributes, however, will be available to offset the target corporation's income and tax liability resulting from the sale.

If a transaction is a taxable asset acquisition from a corporation that has adopted a plan for complete liquidation within a 12-month period, generally no gain or loss is recognized by the selling corporation (except to the extent of recapture and other tax benefit items). Gain or loss is recognized, however, by the shareholders of the liquidating corporation based upon the difference between the amount of the liquidation proceeds received and their stock basis. If the target corporation sells its assets for installment notes that are distributed in liquidation, the target shareholders can report their gain on the installment basis to the extent they receive the notes.

2. Taxable Stock Acquisitions

In General. If a transaction is a taxable stock acquisition, gain or loss generally will be recognized by the selling shareholders, but may be reported on the installment method if installment notes are received. The tax consequences to the target corporation and the acquiring corporation depend upon whether the acquiring corporation makes a section 338 election.

The immediate effect of a taxable stock acquisition is that the target corporation becomes a subsidiary of the purchasing corporation. If no section 338 election is made for the target corporation, no gain or loss is recognized with respect to target's assets and its corporate tax attributes are preserved, subject to certain limitations discussed below. If a section 338 election is made, the taxable stock acquisition takes on most of the characteristics of a taxable asset acquisition from a liquidating target corporation.

Section 338 Elections. A section 338 election is available where one corporation purchases at least 80 percent of the stock of a target corporation over a 12-month period. In such case,

the purchasing corporation may elect to adjust the basis of the assets of the target corporation as though the target corporation sold all of its assets to a new corporation in connection with a plan for complete liquidation within a 12-month period. The price at which the assets are deemed sold by the target corporation and purchased by the new corporation is generally the purchasing corporation's basis in the target's stock at the acquisition date.*/ A section 338 election requires that the target corporation generally recognize its recapture and other tax benefit items as if it had sold its assets pursuant to a plan of complete liquidation.

Section 338 also contains consistency rules designed to prevent a purchasing corporation from obtaining a step-up in basis for some of the target's assets, while preserving target's corporate tax attributes and historic tax basis for other assets. The typical case addressed by these rules is one where target has one group of high value, low basis assets with respect to which the purchaser wants to take depreciation, amortization, and depletion deductions on a stepped-up basis, and another group of assets which may carry either a significant recapture or other tax liability or valuable tax attributes (such as net operating loss or credit carryforwards). If the purchasing corporation were to acquire all of target's assets, all assets would receive a stepped-up basis, target (assuming target liquidated within a 12-month period) would be taxed only on the recapture and tax benefit items on all assets, and the corporate tax attributes of target would be extinguished. From a tax planning perspective, the purchasing corporation would like to step-up the basis of the first group of assets (for instance, by a direct asset purchase), yet avoid the recapture tax and maintain a carryover of basis for

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*/ Section 338(a)(1) provides that the target corporation is deemed to sell its assets at their fair market value on the acquisition date. Alternatively, in the case of a bargain stock purchase, an election may be made under section 338(h)(11) to determine the aggregate deemed sale price on the basis of a formula that takes into account the price paid for the target corporation's stock during the acquisition period (grossed-up to 100 percent) plus liabilities (including taxes on recapture and other tax benefit items generated in the deemed sale) and other relevant items. Section 338(b) provides that the new corporation is deemed to purchase the target corporation's assets at an aggregate price equal to the grossed-up basis of recently purchased stock plus the basis of nonrecently purchased stock (subject to an election under section 338(b)(3) to step-up the basis of such nonrecently purchased stock) plus liabilities (including taxes on recapture and other tax benefit items generated in the deemed sale) and other relevant items.

the second group of assets and the valuable corporate tax attributes of target (by acquiring all of the target stock and not making a section 338 election).

To prevent this type of tax motivated tailoring acquisitions, the consistency rules require that the purchasing corporation must elect either to step-up the basis of all acquired assets (with the associated recapture and loss of corporate tax attributes) or to carry over the basis of all acquired assets (generally with the continuation of tax attributes). Section 338 generally provides that a step-up in basis (and attendant recapture and other tax consequences) will be triggered automatically if, within the period beginning one year before the beginning of the acquisition and ending one year after control is acquired, any member of the purchasing group acquires the stock of any corporation affiliated with the target corporation (target group) or an asset from any member of the target group, other than in certain defined transactions.*/

C. Carry Over of Corporate Tax Attributes

1. In General

Under current law, a corporation that incurs a net operating loss in one year generally is permitted to carry back the loss to offset income earned in the three taxable years preceding the year in which the loss is incurred and to carry forward any excess to offset income earned in the 15 years after the loss is incurred. A net capital loss generally may be carried back to the three taxable years preceding the loss and then carried forward to the five taxable years succeeding the loss. The underlying premise of allowing a corporation to deduct a net operating loss or a net capital loss incurred in one year against taxable income earned in another year is to ameliorate the unduly harsh consequences of an annual accounting system. In other

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*/ The excepted transactions included transactions in the ordinary course of business, carryover basis transactions, pre-effective date transactions, and other transactions to the extent provided in regulations. In some cases, the consistency rules can operate to require taxpayers to take a step-up in basis and pay recapture taxes or suffer other tax detriments where no manipulative scheme exists. As contemplated by Congress in the Tax Reform Act of 1984, Treasury is considering allowing taxpayers to elect carryover basis (or cost basis when less than carryover basis in a particular asset) in all assets that a corporation acquires during the consistency period. We do not believe that the providing of this "carryover basis election" would create any significant new tax incentives for corporate acquisitions provided there are appropriate safeguards.

words, the ability to carry losses back and forward is intended as an averaging device. For similar reasons, corporations that are unable to use all their credits against tax in the year in which the credits are earned may use such excess credits to offset tax liability in the three prior taxable years and the 15 succeeding taxable years.

The ability to carry over net operating losses, unused credits, and other tax attributes following certain corporate acquisitions, as described briefly above, may affect such acquisitions in a variety of ways. The ability to carry over corporate tax attributes, for example, may affect both the form of acquisitive transactions and the price paid or the value of other consideration used in such transactions. Moreover, the ability to carry over tax attributes may in certain instances influence whether an acquisition will be undertaken. The ability to carry over tax attributes after a corporate acquisition, however, is limited under current law in several respects.

As mentioned above, the tax attributes of a target corporation generally survive a tax-free reorganization and carry over to the acquiring corporation. In addition, if a corporation acquires the stock of another corporation in a taxable transaction, the tax attributes of the target corporation also survive the acquisition, unless a section 338 election is made for the target corporation. Moreover, although a purchasing corporation that does not make a section 338 election will not succeed directly to the tax attributes of the target corporation, it may benefit from the target corporation's net operating losses, net capital losses, unused credits, and other tax attributes, if the target and purchasing corporations join to file a consolidated income tax return. Alternatively, a purchasing corporation that does not make a section 338 election may inherit the tax attributes of the target corporation if the target is liquidated or merged into the purchasing corporation.

2. Limitations on the Carry Over of Tax Attributes

Under sections 382 and 383, */ the ability of an acquiring or purchasing corporation to use or benefit from the net operating

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*/ Sections 382 and 383 were substantially amended in the Tax Reform Act of 1976, but the effective date of those amendments has been delayed several times. Most recently, section 301 of the Tax Reform Act of 1986 extended the effective date of the 1976 Act amendments until January 1, 1989. The 1976 Act rules, as well as current law, have been criticized and a number of reform proposals have been made. Although we understand that the Subcommittees are not examining sections 382 and 383 in detail at this hearing, we believe that it is important that Congress address these provisions this year and we look forward to working with the Congress in developing reasonable rules governing the carry over of corporate tax attributes.

losses and other tax attributes of a target corporation following a taxable stock acquisition or a tax-free reorganization may be limited. Sections 382 and 383 were enacted to establish objective tests that would curb "trafficking" in corporations with unused net operating losses and other favorable tax attributes. In the case of net operating loss carryovers, Congress was particularly concerned that profitable, operating corporations were acquiring shell corporations whose principal assets were unused net operating losses that could be applied against income of the acquiring corporations that was unrelated to the business activity of the acquired corporations.

In addition to the specific objective limitations provided by sections 382 and 383, the carry over of net operating losses and other favorable tax attributes may be disallowed under section 269, whenever the principal purpose of an acquisition of stock or assets is to obtain the benefit of losses, deductions, or credits. Thus, section 269 may be applied to deter misuse of the general carryover limitation provisions.

Finally, the ability of an acquiring corporation to benefit from the tax attributes of a target corporation by joining with the target to file a consolidated income tax return is limited by the "separate return limitation year" and "consolidated return change of ownership" rules provided in applicable Treasury regulations. In addition to limiting use of net operating loss and credit carryovers, the consolidated return regulations under certain circumstances also limit the ability to benefit from "built-in" losses following an acquisition.

II. Structural Aspects of the Income Tax That May Encourage Corporate Acquisitions and Takeovers

While we believe economic as opposed to tax considerations typically drive a corporation's decision to acquire another corporation, we recognize that there are a number of structural features of our current income tax system that may encourage corporate acquisitions. The Committee may wish to consider removing or modifying some of the current law provisions that encourage merger activity. As the discussion below will indicate, however, some of the incentives in current law are rooted in the basic structure of how we tax corporations and their shareholders and could not be altered without fundamentally changing the present income tax system.

A. Double Taxation of Corporate Income

Our current income tax system generally treats corporations as taxpaying entities separate from their shareholders. A corporation separately computes and reports its taxable income, and in making this calculation it is not entitled to a deduction for dividends paid to shareholders. Moreover, these dividends

are taxed to individual shareholders as ordinary income (except for a $100 per year exclusion). Consequently, corporate taxable income paid as dividends to individual shareholders generally bears two taxes, the corporate income tax and the individual income tax.

The double taxation of corporate earnings that are distributed as dividends to shareholders affects dividend distribution policies in ways that may encourage merger activity. In particular, corporations, especially those with shareholders in relatively high income tax brackets, are encouraged to retain earnings in order to allow the shareholders to defer imposition of the second tax.*/ This pressure to accumulate corporate earnings not only interferes with ordinary market incentives to place funds in the hands of the most efficient users, but also stimulates corporate acquisitions in at least two ways.

First, corporations that accumulate cash funds in excess of their needs for working capital must reinvest those funds; acquiring the stock or assets of other corporations is an investment alternative that must be considered by any corporation with excess funds to invest. Second, a corporation with large amounts of funds invested in nonoperating assets may become an attractive target, because the market may not immediately reflect the value of those nonoperating assets (which may not generate financial reported earnings commensurate with their values). Because of this potential undervaluation of the target's nonoperating assets, a potential acquiring corporation may view the nonoperating assets as cheap funds available to finance the acquisition of the underlying business operations of the target. The mitigation or elimination of the double tax on corporate dividends, through any form of integration of the corporate and individual income taxes, would reduce or eliminate these effects.

In contrast to the taxation of corporate earnings distributed as dividends, corporate income distributed to creditors as interest is deductible by the corporation and thus taxed only once, to the creditors. The disparate tax treatment of debt and equity in the corporate sector distorts decisions regarding a corporation's capitalization, making corporations more vulnerable to takeover during economic downturns, and also may encourage leveraged buyouts, because interest payments on the debt incurred in such a transaction offset income earned by the target corporation.

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*/ Indeed, in some cases the shareholder-level tax can be permanently avoided if the retained earnings are discontinued in liquidation following the death of the shareholder, which occasions a tax-free increase in the stock's basis to its fair market value. The double taxation of dividends and the tax-free basis step-up at death operate in tandem to place extreme pressure on closely-held corporations to retain rather than distribute earnings.

Since interest payments on debt financing are deductible and dividends paid on equity are not, corporations are encouraged by the tax law to utilize debt rather than equity to finance their ongoing operations. This may result in an increased debt to equity ratio that increases the risk of bankruptcy and vulnerability to downturns in the business cycle; and any corporation that is temporarily crippled by an economic downturn becomes a likely takeover candidate. The incentive for leveraged buyouts conferred by the more favorable tax treatment of interest payments is discussed further in part III.A.1., below.

B. Capital Gain - Ordinary Income Distinction

Currently, corporations are subject to tax on ordinary income at a maximum rate of 46 percent and on capital gains at a maximum rate of 28 percent. Individuals are subject to tax on ordinary income at a maximum rate of 50 percent and on capital gains at a maximum rate of 20 percent. While corporate taxable income distributed to individual shareholders as dividends generally bears two ordinary income taxes, the shareholder's receipt of cash or property in exchange for his stock in a purchase of the corporation results in a significant lessening of the double tax burden when compared with the receipt of such cash or property as dividend income. Even though corporate earnings distributed as dividends would be taxed to the shareholders at ordinary income tax rates, the gain attributable to retained earnings is taxed at preferential capital gains rates if the shareholders sell their stock. This capital gain opportunity results in an incentive for the corporations to retain income in corporate solution and for corporate acquisitions.

C. Underutilization of Capital Subsidies

Capital subsidies (such as certain credits and accelerated depreciation) provided through the tax system may have an unintended ancillary effect of encouraging mergers and acquisitions. In some cases the amount of these tax subsidies have outstripped the recipient corporation's ability to use them effectively by investing in operating assets. To the extent that a corporation cannot effectively reinvest the tax subsidies in operating assets, such amounts are invested in nonoperating assets, which stimulate merger activity as detailed in part III.A., above.

In addition, whenever a company does not have enough income and tax liabilities to benefit from the accelerated depreciation and tax credit capital subsidies, an incentive for mergers is created. An acquisition, there are limitations on the use of tax attributes of an acquired corporation, but these limitations do not apply to certain forms of mergers or acquisitions. And even in cases in which the limitations apply, the acquiring corporation may nevertheless benefit to some extent from the target corporation's tax attributes.

For example, the limitations provided in sections 382 and 383 generally would not apply if a corporation with substantial unused net operating losses and excess credits acquired a profitable target corporation's stock or assets in either a tax-free or taxable acquisition. Accordingly, income and tax liability generated by the target corporation or its assets could be offset in future years by the acquiring corporation's unused tax attributes. Similarly, if an acquiring corporation purchased the stock of a target corporation in a taxable acquisition and did not make a section 338 election, the acquiring corporation could use the target corporation's net operating losses to offset future income of the target corporation. If, on the other hand, the acquiring corporation made a section 338 election, although it would not succeed to the target corporation's tax attributes, any income realized by the target corporation by virtue of the section 338 election and the accompanying tax liability could be offset by the target corporation's net operating loss and credit carryforwards.

The ability to benefit from net operating loss and other carryforwards following the acquisition of a corporation is not necessarily inconsistent with sound tax policy. As discussed earlier, a corporation is allowed to carry back and carry forward its unused net operating losses and credits without limitation (other than on the number of carryback and carryforward years). These unused net operating losses and credits may result from capital subsidies to which the corporation is entitled, but is unable to utilize currently. The carry over of net operating losses and other tax attributes following a corporate acquisition may properly allow the target corporation to effectively benefit from the capital subsidies in the same manner as if no acquisition had occurred. Nevertheless, the tax rules governing the carry over of tax attributes should not encourage corporate acquisitions that would not be undertaken on purely economic grounds. Moreover, those rules should not result in tax attributes becoming more valuable in the hands of an acquiring corporation than they would have been in the hands of a target corporation.

In general, we believe that the existing limitations on the carry over of corporate tax attributes do not work well in some respects and improperly allow the carry over of tax attributes in some cases. We do not believe, however, that either the ability to carry over tax attributes in a corporate acquisition or the imperfections in the existing statutory and regulatory limitations on such carryovers is the fuel driving the recent surge of corporate acquisitions. Nevertheless, we do look forward to working with the Congress in reforming those rules this year.

We want to point out, however, that the existence of unused tax attributes and the ability to benefit from such attributes by acquiring control of a corporation would be of much less concern

if corporate taxable income were measured correctly and, for example, the existence of unused net operating losses meant that a corporation had realized actual economic losses. Under current law, however, a corporation that earns a significant profit may nevertheless have substantial net operating losses and other unused tax attributes. Current law does not provide for direct reimbursement of net operating losses or refundability of credits by the Federal government and does not permit corporations with unused tax attributes to transfer those attributes freely to other corporations that can benefit from them. The consequence of such a system is the existence of an increased volume of tax attributes that can not be used by the corporations to which they are made available. The lack of refundability or free transferability and the resulting increase in the volume of unused tax attributes place significant pressure on the rules that are designed to limit the use of net operating losses and excess tax credits following an acquisition and provide an incentive to acquire corporations with such unused tax attributes.

Moreover, the mismeasurement of income for tax purposes and the resulting increased volume of unused tax attributes may favor conglomeration by encouraging corporations that are engaged in business activities that generate "tax losses" and excess tax credits to combine with other corporations that are engaged in activities with fewer tax attributes. The tax laws should not create such a bias between diversified and non-diversified entities.

The adoption of a system that correctly measures economic income would eliminate the possibility that profitable corporations could have unused net operating losses or excess tax credits and would ensure that companies with loss carryforwards had suffered equivalent economic losses. The importance of rules limiting the use of tax attributes following corporate acquisition would thus be decreased. The proper measurement of corporate income also would greatly diminish the volume of unused favorable tax attributes, and correspondingly reduce the importance of tax attributes in decisions regarding corporate acquisitions and conglomeration.

D. General Utilities Doctrine

Some have argued that the section 338 rules and the liquidation rules conflict with the general scheme for taxing a corporation and its shareholders and may encourage corporate acquisitions. Generally, as described above, a corporation is subject to tax on the profits derived from its operations and its shareholders are subject to a second level of tax on the distributions of those profits as dividends. In a liquidating sale of assets or sale of stock with a section 338 election, there is a step-up in basis of assets with only a partial corporate level tax; recapture and tax benefit items are taxed, but other potential gains are not. This result stems from the

rule attributed to General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), that is now codified in sections 311(a), 336, and 337. Under those provisions, a corporation recognizes no gain (other than recapture and tax benefit items) on distributions, including liquidating distributions, made to its shareholders. These rules may give an additional incentive to a corporation to sell assets in some cases because it increases the likelihood that the present value of the tax benefits that accompany property ownership (e.g., depreciation and depletion deductions) may exceed the seller's tax detriment incurred on the sale. Thus, the same assets may be more valuable to a buyer than to the current owner.

Congress has reduced this incentive to sell corporate properties by limiting the scope of the General Utilities rule. For example, TEFRA made distributions of appreciated property in a partial liquidation taxable to the distributing corporation. In addition, the Tax Reform Act of 1984 (the "1984 Act") imposed the same treatment on dividend distributions of appreciated property. One major aspect of the General Utilities doctrine remains, however. Nonrecognition of gain by the selling corporation continues to be the general rule in connection with a complete liquidation and a deemed asset sale in connection with a section 338 election (although recapture and tax benefit items are taxed). While repeal of this last major exception would simplify the tax laws, we do not believe that the failure of the corporate tax regime to impose two levels of tax on liquidation transactions is primarily motivating corporate acquisitions. Further, as we have indicated in prior testimony before the Senate Finance Committee, we believe that in considering the repeal of General Utilities in liquidation transactions, relief from double taxation of liquidation proceeds must also be considered.

E. Inadequate Recapture Taxes

1. In General

Some have suggested that the imperfections in the current recapture rules may be a factor encouraging corporate mergers and acquisitions. If the General Utilities rule were fully repealed and a corporation were required to recognize gain to the extent the amount realized exceeds its basis in assets, the effectiveness of the recapture rules would not be as important. Short of a complete repeal of the General Utilities rule in a liquidation context, it may be appropriate to tighten current recapture rules. For example, under current law, a liquidating corporation that used the last-in first-out ("LIFO") method of accounting for inventories is required to recognize income attributable to the difference between the value of inventory determined on the LIFO basis and that determined on a first-in first-out ("FIFO") basis (commonly called LIFO reserve). This rule could be expanded to include all inventory profit (not just

the difference between LIFO and FIFO) and all other ordinary income. In addition, the recapture rules on section 1250 property (including residential real estate) could be conformed to the section 1245 recapture rules applicable to personal property to require the liquidating corporation to recapture ordinary income to the extent of the full amount of prior depreciation allowed. These changes would be premised on the notion that the corporation claiming tax benefits should return those benefits at the time of sale (whether by actual sale or in liquidation) if the sale shows that the earlier granted benefits were excessive.*/ Any strengthening of the recapture rules, however, magnifies the potential double taxation of corporate earnings and any change in the recapture rules should be coordinated with proposals to relieve that double tax burden.

2. Mineral Property

Under current law, gain on the disposition of mineral property is recaptured as ordinary income under section 1254 to the extent of intangible drilling costs that were deducted after December 31, 1975. There is no recapture, however, with respect to gains from the sale of mineral property for which intangible drilling costs were deducted prior to that date. Consequently, on the sale or exchange of mineral properties, gain attributable to expenses deductible against ordinary income as intangible drilling costs prior to 1976 is taxable at capital gain rates even though the drilling expenses were deducted against ordinary income.

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*/ It should be noted that recapture and tax benefit items generally are not recognized upon the sale of a subsidiary. However, such a result may be inconsistent with the basic principles of the recapture rules where the selling corporation and its subsidiary joined in filing a consolidated return for all years in which the deductions (or credits) were claimed. The consolidated return regulations provide for an annual basis increase (or decrease) in the parent's stock in the subsidiary based on the annual increase (or decrease) in earnings and profits, rather than taxable income, of the subsidiary for such year. Some have suggested that these rules may permit the selling parent corporation to understate its gain (as well as avoid recapture income) because the basis of the subsidiary's stock is inappropriately increased whenever the earnings and profits increase in an amount greater than taxable income. This disparity between earnings and profits and taxable income typically is due to certain tax subsidies, such as accelerated depreciation. The Internal Revenue Service takes the position that allowing this basis increase would result in impermissible double deductions to the selling affiliated group and is currently litigating this issue.

Prior to 1975 integrated oil companies could deduct percentage depletion at a rate of 22 percent with respect to mineral property. Percentage depletion deductions are not limited to the taxpayer's basis in the mineral property; so that, with respect to pre-1975 properties, the adjusted depletable basis (investment costs other than intangible drilling costs) for most taxpayers is zero. Since 1975, however, integrated oil companies have been required to use cost depletion. Thus, in effect, most integrated oil companies receive no depletion allowances if they continue to produce from pre-1975 properties. Upon a disposition of mineral property to another who would be allowed cost depletion for the same property, current law does not require recapture of either cost or percentage depletion allowances; this rule applies whether or not percentage depletion allowances were taken in excess of the taxpayer's basis.

Some have suggested that recapture rules should be applied to intangible drilling costs deducted in respect of mineral properties regardless of when the deductions were taken. We cannot support such a change. The recapture of intangible drilling costs was considered extensively by Congress in connection with legislation in 1976. Congress enacted a recapture provision at that time and settled upon what it considered to be a fair transition rule. We do not believe that it is appropriate to change that transition rule retroactively.

Suggestions also have been put forth to apply recapture rules to percentage and cost depletion allowances. Normally, as in the case of depreciable personal property, recapture of depreciation is provided when the property is sold or exchanged; only the excess of the selling price over original basis is eligible for capital gains rates (and nonrecognition at the corporate level in a liquidating sale). The lack of adequate recapture rules creates an incentive to sell to a buyer who will obtain the benefit of a step-up in basis (and therefore larger deductions against ordinary income) at the cost of only a capital gains tax to the seller. The failure to recapture cost depletion allowances thus may provide some incentive for acquisitions of companies with mineral properties. We do not believe the recapture rules applicable to mineral property should differ from the current recapture rules applicable to personal property. In either case, full recapture is needed to minimize inefficient churning of such property solely for tax reasons.

Although we would support full recapture of cost depletion, we would not support the application of recapture rules to percentage depletion. The percentage depletion allowance is, in effect, a negative excise tax on the production of minerals which results in a lower effective income tax rate for those eligible for its benefits. While it may be appropriate to consider reducing or eliminating future allowances for percentage depletion, we do not believe the special rate of tax on mineral properties that Congress provided by way of the percentage

depletion allowance should be retroactively repealed by extending the recapture rules. Congress dealt with the policy considerations involving the availability of this special tax incentive to integrated oil companies by limiting such taxpayers to cost depletion for taxable years ending after December 31, 1974.

III. Recent Developments in Corporate Acquisitions that Raise Significant Tax Policy Issues

The structural aspects of the current income tax law discussed above may encourage merger and acquisition activity to some degree, but as stated at the outset, we do not believe they are the driving force behind the current flurry of activity. A number of the publicized acquisitions that are of interest to the Committees involve tax techniques that have only recently evolved, and to some extent these techniques are based upon recently enacted tax incentives. We are concerned that these tax incentives are being employed in mergers and acquisitions in ways that Congress did not intend. Principal among our concerns are the use of ESOPs in leveraged buyouts and the carryover of tax attributes in mergers and acquisitions of thrift institutions. I would also like to comment upon the growing use of asset reversions from overfunded defined benefit plans to finance mergers and acquisitions.

A. Leveraged Buyouts and the Growing Use of ESOPs

1. Leveraged Buyouts

The prototypical leveraged buyout involves the conversion of a publicly held company into a private company pursuant to an acquisition by a newly organized private company of all of the target company's stock. The acquiring company usually is organized and controlled by the senior management of the target company. The private company's acquisition of the target stock is largely debt financed, with the expectation that the debt will be retired out of future earnings of the company.

As is the case with other mergers and acquisitions, we expect that leveraged buyouts are motivated primarily by economic factors. Nevertheless, the income tax law to some extent may encourage leveraged buyouts of corporations by the more favorable tax treatment of interest payments. As discussed earlier in part II.A., the deductibility of interest payments by a corporation compared to the nondeductibility of dividends encourages corporations to use debt rather than equity in financing operations or acquisitions because of the potential for double taxation of corporate earnings distributed as dividends.

The deductibility of interest incurred in connection with debt-financed acquisitions also encourages these acquisitions to the extent that our tax system does not take account of inflation properly. Nominal interest rates typically include an inflation component which compensates the lender for the anticipated future reduction in the real value of a fixed dollar amount debt obligation and acts as an offsetting charge to the borrower for the inflationary reduction in the value of the principal amount of the borrowing. Where borrowed funds are invested in assets that also increase in value by virtue of inflation, the tax law permits a current deduction for interest expenses but no realization of the increase in value of the asset until its sale or disposition. In such cases the interest deduction can be used to offset income that otherwise would be taxed currently.

The use of installment debt in acquisitions leads to significant mismatching of the gain that is deferred by the seller and the allowance to the purchaser of depreciation, amortization, or depletion deductions determined by reference to asset values that have been stepped-up to fair market value as a result of the acquisition. This asymmetrical treatment of a sale, under which the buyer is treated as acquiring full ownership of the asset while the seller is treated as making only partial sales each year over the term of the contract may create a tax bias for installment debt-financed acquisitions. In a taxable corporate acquisition (an asset acquisition or a stock acquisition with a section 338 election), this mismatching is reduced to some extent if the target corporation's assets are subject to recapture tax since the recapture income is recognized immediately. The asymmetrical treatment arising from installment sales debt is a problem that should concern these Committees, but the problem exists in every installment sale of a depreciable asset and is by no means unique to corporate acquisitions.

The tax arbitrage from debt financing generally is available for all debt-financed assets, not just those acquired in a corporate merger or acquisition. The only special limitation on the deductibility of interest on debt incurred in acquisitions is found in section 279 which applies only under very limited circumstances. Although it may be appropriate to give consideration to revising the general rules regarding the deductibility of interest we see no justification for a further limitation on the deductibility of interest expense that is aimed specifically at debt incurred in connection with corporate acquisitions.

2. Leveraged Employee Stock Ownership Plans

While every leveraged buyout raises the concerns just noted, we have particular concerns about the use of leveraged employee stock ownership plans (ESOPs) to effectuate leveraged buyouts and to defend against attempted takeovers. Since Congress first

established special tax incentives for ESOPs, these plans have been used frequently in leveraged buyouts, but the 1984 Act makes ESOPs an even more attractive vehicle for purchasing shares in a leveraged buyout.

In a leveraged ESOP, the ESOP borrows to purchase stock of the company that establishes the ESOP, and the company obligates itself to contribute amounts to the ESOP sufficient to enable it to service the debt. The employer may deduct these contributions to the ESOP currently without regard to the restrictive limits on employer contributions to other types of employee benefit plans. Because the ESOP is a qualified plan, an employee participating in the ESOP is not required to include these contributions in income until he or she receives a distribution from the plan.

Under the terms of a typical leveraged ESOP, employees are not entitled to distributions from the plan until separation from service. When the ESOP distributes stock to a participant, the employee is taxed on the value of the stock (determined with reference to the price paid by the ESOP) and accumulated income which has been allocated to the participant's account. A participant has the right to require the employer to purchase the stock from the participant at fair market value, unless the stock is readily marketable and traded on an established securities market.

An ESOP is required to give covered employees the right to vote publicly traded shares held by the ESOP. But employees can vote shares held by the ESOP that are not publicly traded, only with respect to actions (such as mergers or liquidations) which require an affirmative vote of more than a majority of the corporation's shares.

It is possible that the nominal beneficiaries of the ESOP, the corporation's employees, will obtain little current benefit from the arrangement. This is true because, while the ESOP may own a significant percentage of the outstanding employer securities, a participant employee will not realize the value of the securities originally purchased by the ESOP until separation from service. Finally, because leveraged buyouts involve privately held corporations, the employees generally are entitled to only very limited voting rights with respect to ESOP stock.

Despite the uncertainty of the benefits that an ESOP confers on covered employees, in the 1984 Act Congress expanded the incentives for employee stock ownership through ESOPs in four ways: (1) banks, insurance companies, and other commercial lenders may exclude one-half of the interest paid or accrued on a loan the proceeds of which are used by a leveraged ESOP to purchase qualified stock; (2) taxpayers are permitted to defer gain from the sale of stock to an ESOP if the proceeds are used to purchase stock in a second corporation; (3) corporations may deduct dividends paid to employees with respect to stock of the employer held in an ESOP or stock bonus plan; and (4) an ESOP may assume the estate tax liability with respect to stock of a closely held business which is transferred to the ESOP.

Historically, the employer's right to deduct ESOP contributions while the employees participating in the ESOP defer income has been a significant subsidy which has made the use of ESOPs a favored vehicle for leveraged buyouts. The 1984 Act, however, so enhanced the tax benefits available to leveraged ESOPs that we believe not only will the use of ESOPs in leveraged buyouts increase, but the total number of leveraged buyouts may actually increase. In addition, we expect that these new incentives will greatly increase the use of leveraged ESOPs to defend against potential takeovers.

The most significant of the new incentives for the use of ESOPs in leveraged buyouts is section 133 of the Code which permits banks, insurance companies, and other commercial lenders to exclude one-half of the interest paid or accrued on a loan the proceeds of which are used by a leveraged ESOP to purchase qualified stock. This permits lenders to charge a lower interest rate and thus lower the costs of acquiring employer securities through an ESOP. We understand that the subsidy provided under section 133 allows qualifying lenders to provide financing to an ESOP at approximately 80 percent of the otherwise available interest rate. For example, if the rate available to the ESOP would be 10 percent without regard to section 133, the ESOP could save approximately $140,000 in interest charges on a ten-year, level payment, $1,000,000 obligation, assuming an actual interest rate of 8 percent. Such a significant reduction in the cash flow required to finance an acquisition is certain to stimulate leveraged buyouts.

The 1984 Act provisions also created an incentive for owners of businesses to sell to their ESOPs rather than to others. New section 1042 allows a shareholder to defer the gain on the sale of shares in the corporation to an ESOP if certain requirements are met. Presumably, the availability of deferral for a shareholder selling to an ESOP will result in a lower purchase price for the shares to the ESOP. Although our limited experience with this provision makes it impossible to know to what extent the special tax benefit to the selling shareholder will be reflected in the price to the ESOP, any reduction in the cost of acquiring a corporation through an ESOP will obviously create a further incentive for leveraged buyouts through ESOPs.

The cumulative effect of these subsidies is to create substantial tax incentives for leveraged buyouts through ESOPs. These benefits inure to those in a position to establish an ESOP and through that device to take a public company private. It also appears that ESOPs are frequently employed as a defensive takeover tactic. These tactics may have an unnecessary dampening effect upon otherwise advisable mergers and acquisitions. Although the goal of encouraging employee ownership may be worthwhile, we believe that any examination of mergers and acquisitions should include an examination of the effects on mergers and acquisitions of the indirect subsidies provided through the current tax provisions relating to ESOPs.

C. Overfunded Defined Benefit Plans

Concern also has been expressed recently about the involvement of overfunded qualified defined benefit plans in corporate mergers and acquisitions. Under current law, a company may terminate its defined benefit plan and receive any assets that are in excess of the present value of the participants' accrued benefits as of such termination. There are no restrictions on the company's use of such excess assets.

Because overfunded defined benefit plans thus constitute relatively attractive sources of cash, companies with significantly overfunded plans are thereby made more attractive takeover targets. There are several recent examples of acquiring companies terminating target companies' overfunded plans to partially fund the acquisitions. Also, it is not surprising that other companies have terminated their own overfunded plans to reduce the readily available pool of assets to which the companies have access and thereby to make themselves less attractive to other companies. These companies generally have used the excess assets to make less liquid investments (such as equipment purchases), to finance "going private" transactions, or to take defensive actions (such as establishing an ESOP to hold company stock) against potential takeover attempts. Finally, some companies have terminated their overfunded plans to use the assets offensively in their own takeover initiatives or to retire debt incurred in completed takeover transactions.

In assessing the role of defined benefit plans in mergers and acquisitions, one should understand the essential features of such plans and why and in what sense they are overfunded. The law grants favorable tax treatment to employer-maintained retirement plans that satisfy various qualification requirements. There are two types of qualified retirement plans: defined contribution plans and defined benefit plans. Under a defined contribution plan, a participant's accrued benefit is equal to the value of the assets allocated to such participant's account and all plan assets are allocated to participants' accounts. Thus, no assets are available for employer recoupment.

Under a defined benefit plan, however, the participant's accrued benefit is determined under a benefit formula, which generally is based on the participant's compensation and years of participation in the plan. The company maintaining the plan (the sponsor) has the responsibility to make sufficient contributions to the plan to maintain a pool of funds sufficient to provide the participants' promised retirement benefits as they come due. Accordingly, unlike a company maintaining a defined contribution plan, the sponsor of a defined benefit plan bears the full risk of investment gains and losses in the plan's assets.

There are numerous reasons why a defined benefit plan may, at any particular time, hold assets in excess of the present value of participants' accrued benefits at such time. The most basic reason is the inherent nature of the sponsor's obligation to fund a defined benefit plan, as reflected in the minimum funding standards of section 412 of the Code. These standards generally require that a sponsor fund the plan on a "going concern," rather than a "termination," basis. This means that sponsors must currently fund not merely accrued benefits, but also some portion of participants' projected benefits at normal retirement age. In projecting future benefits, future salary increases and inflation ordinarily are considered. In addition, in order to avoid an ever-increasing funding obligation as its workforce ages, a sponsor may choose to fund its plan in accordance with a level-funding actuarial funding method that tends to accelerate contributions relative to the rate of benefit accrual. As a consequence of the natural operation of the funding rules, a defined benefit plan that is not fully funded on a going concern basis may well be overfunded on a termination basis.

The actuarial methods commonly used in determining sponsors' defined benefit funding obligations rely on long-term assumptions regarding such items as investment returns and salary increases. To the extent that plan investments earn more than anticipated or salaries increase less than expected, overfunding will tend to be greater. For example, during recent years, the rates of return on equity investments have exceeded most actuarial assumptions, which themselves tend to be quite conservative, and salary increases have generally been less than expected.

Furthermore, in determining a defined benefit plan's excess assets, it is necessary to calculate the present value of participants' accrued benefits. The higher the interest rate assumption used in this calculation, the fewer assets are necessary to provide participants' accrued benefits. During recent years, insurance companies have been pricing both immediate and deferred annuity contracts for terminating defined benefit plans using recent high interest rates. By reducing the current cost of providing for participants' accrued benefits upon plan termination, this has contributed significantly to the excess termination-basis funding of many defined benefit plans.

Finally, within certain limits (section 404 of the Code), a sponsor is permitted to deduct defined benefit plan contributions in excess of the required contribution under the minimum funding standards. This may of course encourage further employer contributions to a plan, particularly in profitable years, and consequently larger overfunding.

The tax law requires a defined benefit plan to be maintained for the exclusive benefit of the participants and their beneficiaries. In addition, it must be impossible at any time

prior to the satisfaction of all liabilities with respect to the sponsor's employees and their beneficiaries under the plan, for any part of the plan's assets to be used for, or diverted to, purposes other than the exclusive benefit of the employees and their beneficiaries. Because it is not possible to satisfy all plan liabilities before plan termination, a sponsor may recoup plan assets only by terminating its plan. And, in this regard, because a sponsor may voluntarily establish a qualified plan and may voluntarily terminate its plan as it desires, this particular restriction rarely poses a practical obstacle.

A significantly overfunded defined benefit plan thus may be seen, both from the sponsor's perspective and from the perspectives of other companies that may be interested in attempting to take over the sponsor, as a relatively accessible and attractive pool of liquid assets. Of course, the desire to recoup excess plan assets is not limited to companies involved in merger and acquisition transactions. Any business need that requires significant financing--e.g., diversification, expansion of capacity, modernization, advertising--may be sufficient motivation. Nevertheless, due to the substantial cash requirements of acquisitions and acquisition-related transactions, it is natural that companies involved in such transactions will look to defined benefit plans as a potential source of ready funds.

While any assets received upon plan termination must be included in income, the sponsor is entitled to offset this inclusion by any available deductions and credits (including interest deductions and loss carryovers). Thus, because the decision to terminate is in the hands of the plan sponsor, it frequently is possible to time the termination so that none or only a small portion of the assets is subject to tax. To the extent a sponsor is able to achieve this result, terminating an overfunded defined benefit plan becomes more attractive.

One of the primary concerns expressed about the terminations of defined benefit plans to recoup plan assets is the security of the participants' benefits. Under current law, there is no requirement that participants continue to accrue benefits after a plan has terminated. It is thus inevitable that where a sponsor terminates a defined benefit plan and does not establish any other plan in its place, participants will not receive the benefits at retirement that they would have received--and may well have expected to receive--if the plan had not been terminated. In a voluntary pension system, there is very little that the government can do to prevent such terminations beyond assuring that all of the participants' benefits as of the termination are adequately provided.

Of greater recent concern, however, have been reversion transactions under which a sponsor receives plan assets while effectively continuing to maintain the defined benefit plan.

These transactions generally have taken two forms: (1) the termination of the defined benefit plan and the establishment of a new defined benefit plan, often identical to the terminated plan (reestablishment transaction); and (2) the spinoff of a defined benefit plan into two plans, one for active employees and one for retirees, the allocation of the excess assets to the retirees' plan, the termination of the retirees' plan, and the continuation of the defined benefit plan for the active employees (spinoff transaction).

In May 1983, the ERISA agencies (the Department of Treasury, the Internal Revenue Service, the Department of Labor, and the Pension Benefit Guaranty Corporation) issued enforcement guidelines (the Guidelines) for purposes of processing reestablishment and spinoff transactions. By requiring the full vesting of all benefits and the purchase of annuity contracts from insurance companies guaranteeing participants' accrued benefits, the Guidelines assure that the security of participants' benefits accrued before the transaction is not adversely affected. In addition, the Guidelines attempt to impose substantive parity between reestablishment transactions and spinoff transactions by requiring the continuing plan in the spinoff transaction to satisfy all of the substantive requirements of a formal termination--e.g., full vesting of benefits, formal notice to participants, and third-party annuitization of benefits. Moreover, the Guidelines extend additional security to plan participants in the continuing plans with respect to benefits accrued after the transactions by strengthening the funding requirements under such plans. Finally, the Guidelines prevent a sponsor from undertaking reestablishment and spinoff transactions on a regular basis by specifying that such transactions may not be undertaken more than once every fifteen years.

We believe that, within the confines of existing administrative authority, the Guidelines appropriately protect the interests of participants in plans that are involved in reestablishment or spinoff transactions. We recognize that some believe that additional protections are necessary, but we are comfortable that the Guidelines strike the proper balance between assuring the security of participants' benefits and not encouraging defined benefit plan sponsors to terminate their plans without establishing a successor plan. We do not believe that legislation with respect to these specific transactions is necessary.

Similarly, it is our view that the recent involvement of overfunded defined benefit plans in acquisitions and acquisition-related transactions does not warrant specific legislation to limit the rights of plan sponsors to terminate their defined benefit plans as they desire. We are concerned that any such legislative action to curb the termination of plans may

unnecessarily discourage employers from maintaining or properly funding defined benefit plans. We must be careful not to undermine the voluntary nature of the pension system in an attempt to dampen related merger and acquisition activity.

We recognize, however, that, in the context of a broader examination of pension and tax policy, it is appropriate to consider action to reduce the general incentive for plan sponsors to terminate plans and extract assets for nonretirement purposes. The impetus for any such action should not, however, be the involvement of overfunded plans in acquisition transactions--although this certainly would a factor to be considered--but rather should be based only on a full consideration of the applicable pension and tax policies. Thus, any proposal to reduce the incentive to terminate defined benefit plans should apply on an across-the-board basis, without regard to either the reason the sponsor is terminating the plan or the intent of the sponsor to establish a successor plan. For example, after further deliberations, it may be appropriate on pension and tax policy grounds to apply a special excise or minimum tax to asset reversions. This or similar action would reduce the attractiveness of terminating overfunded defined benefit plans in all circumstances.

D. Special Problems With Respect To Carry Over of Tax Attributes of Thrift Institutions

In the Economic Recovery Tax Act of 1981 ("ERTA"), Congress amended Section 368 of the Code to provide rules relating to bankruptcy reorganizations of thrift institutions (i.e., savings and loan associations and savings banks). These changes, proposed by the Federal Home Loan Bank Board (the "Bank Board"), were designed to resolve the issue of how the continuity of interest requirement applies in reorganizations involving thrift institutions.

Prior to ERTA, the Internal Revenue Service took the position that a merger of a stock association into a mutual association could not qualify as a tax-free reorganization. The Service reasoned that the exchange of the shareholders' stock for deposits in the mutual fails to satisfy the continuity of interest requirement because the deposits are cash equivalents. The courts generally rejected the Service's position, but without the concurrence of the Internal Revenue Service, combinations of stocks and mutuals could not be assured tax-free status.*/

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*/ The Supreme Court recently sustained the Service's position in Paulsen v. Commissioner, ___ U.S. ___, 105 S. Ct. 627 (1985), ruling that the merger of a stock into a mutual does not satisfy the continuity of interest requirement. In this case, which arose prior to ERTA, the Court held that the interests of the former shareholders of the stock association in the mutual were essentially cash equivalents and, thus, the transaction failed the continuity of interest test.

There was also uncertainty as to the application of the continuity of interest requirement in reoganizations involving thrifts under section 368(a)(1)(G) ("G reorganizations"). In many reorganizations involving thrifts, the transferor's solvency was in question and the Internal Revenue Service took the position that the transaction could qualify as a tax-free acquisition only if it satisfied the G reorganization requirements. However, it was not clear how the continuity of interest requirement applied in a G reorganization involving thrifts. In the case of a mutual association there are no stockholders and the principal creditors are depositors whose interests generally are insured and who are not likely to exchange those claims for stock. Further, stock associations were unwilling to issue stock to those depositors. Consequently, it appeared that the continuity of interest requirement generally barred the reorganization of a thrift from qualifying as a tax-free G reorganization.

To resolve these issues, Congress lifted the continuity of interest requirement in G reorganizations involving a transferor thrift if certain requirements are met. Generally, under these rules, a transaction otherwise qualifying as a G reorganization, in which the transferor is a financial institution to which section 593 applies, will not be disqualified merely because no stock or securities of the transferee are issued, provided: (i) the transferee acquires substantially all of the assets of the thrift and the thrift distributes any remaining assets pursuant to the plan; (ii) substantially all of the liabilities of the thrift (including deposits) become liabilities of the transferee; and (iii) the appropriate agency certifies that, under 12 U.S.C. §1464(d)(6)(A)(i), (ii) or (iii), either that the transferee thrift is insolvent, the assets of the thrift are substantially dissipated, or the thrift is in an unsafe and unsound condition to conduct business. The Bank Board, the Federal Savings and Loan Insurance Corporation ("FSLIC") or, if neither has supervisory authority over the thrift, the equivalent state authority may certify that one of the grounds specified in 12 U.S.C. §1464(d)(6)(A) exists. In addition, section 382(b)(7)(B) was added to provide that the transferee's and transferor's depositors are taken into account in determining the level of continuity of interest for purposes of section 381.

In these acquisitions a profitable financial institution typically agrees to assume the transferor thrift's obligations in consideration for payments from a regulatory body, such as the FSLIC, and the right to succeed to the transferor's tax attributes. The tax attributes which the acquiring corporation seeks to preserve are the thrift's accumulated net operating

losses and other carryforwards and the transferor thrift's basis in its assets (typically residential mortgages with basis significantly above fair market value).*/

In tax-free reorganizations the continuity of interest requirement limits tax-free treatment to those transactions in which the owners of the target corporation receive a meaningful ownership interest in the acquiring corporation. The transfer of stock in the target corporation for stock in the acquiring corporation is tax-free because the owners of the target corporation are deemed to have merely changed the form of their investment. Moreover, the notion that tax attributes carry over in a tax-free reorganization hinges on the continuity of interest doctrine. The tax law considers it appropriate for tax attributes to be used to offset income earned after the acquisition whenever the historic shareholders who incurred the unused attributes continue to hold a sufficient equity position after the reorganization.

Under the revised rules for thrifts, neither the stockholders nor the creditors (i.e., the depositors) of the troubled thrift receive a continuing ownership interest in the acquiring corporation. To permit tax attributes to carry over in these transactions thus departs from the traditional principles underlying the tax-free reorganization provisions, and provides a tax subsidy for private acquisitions of thrift institutions. In effect, this subsidy may operate to shift some or all of the burden of thrift losses from FSLIC, the private insurance agency funded by the thrift industry, to the Federal government. Congress thus should consider carefully whether subsidies for the thrift industry are necessary, and whether they should be made through direct appropriations or through the tax laws, recognizing that the latter route may be less efficient and more costly in the long run. We recognize, however, that the thrift industry is undergoing a period of restructuring and there may be nontax considerations for encouraging the flow of capital into the thrift industry.

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*/ This carryover basis would leave the transferee with substantial built-in losses which could be realized merely by selling the loans. Alternatively, if the transferee does not sell the loans, the carryover basis permits the transferee to treat payments other than stated interest as repayments of principal; if the transferee took a fair market value basis in the loans, a portion of the "principal" repayments would constitute market discount under section 1277 and thus be treated as ordinary income.

If the thrift reorganization rules are retained, we also suggest that these Committees examine whether the special thrift reorganization rules should be limited to acquisitions of a thrift by a bank or another thrift. These provisions were enacted to facilitate the rehabilitation of a thrift through its acquisition by another thrift under the supervisory powers of a certifying agency. Although the statutory language and the legislative history do not explicitly suggest that these provisions are limited to acquisitions of troubled thrifts by other depository institutions, strong concerns existed in 1981 that these special rules not be used to permit the ready transfer of realized and built-in losses of a troubled thrift to a corporation other than a depository institution. Indeed, the Bank Board, in seeking this legislation, assured the staffs of the tax-writing committees and the Treasury Department that the principal purpose of the legislation was to remove the technical obstacles to supervised mergers involving troubled thrift institutions.

We have become aware that these special rules are being used increasingly to facilitate mergers of troubled thrifts and corporations outside the banking sector. Though these acquisitions may technically satisfy the statutory requirements, the potential transfer of tax losses of troubled thrift institutions to corporations other than banks or other thrifts goes beyond the intended scope of the ERTA provisions. To date, the Internal Revenue Service has not issued rulings involving troubled thrifts where the principal trade or business of the acquiring corporation is unrelated to banking. Thus, if thrift reorganizations are to be continued, we urge that Congress clarify the scope of these provisions.

IV. Current Legislative Proposals

In response to the current flurry of merger and acquisition activity, a number of bills have been introduced in Congress that would use the tax laws to discourage these transactions. I will comment on several of these bills, but will not discuss any of them in detail.

It has been proposed that more stringent tax consequences attach to a stock acquisition that is effected pursuant to a hostile takeover (generally, one disapproved by a majority of the independent members of the board of directors of the target corporation). An automatic section 338 election would be deemed made, and all gain on the target corporation's assets, not just recapture and tax benefit items, would be recognized. We do not believe that the tax laws should be used to discourage hostile takeovers. If it is concluded that hostile takeovers harm shareholders or the economy, Congress should address its concerns directly. As a matter of tax policy we do not believe "hostile" acquisitions should be treated differently under the tax laws than "friendly" acquisitions.

It has also been suggested that so-called "greenmail" profits be subject to a 50 percent excise tax, and that no deductions be allowed for "greenmail payments" or interest on indebtedness incurred to acquire stock or assets acquired pursuant to certain hostile acquisitions. While we would not object to a statutory confirmation that under current law "greenmail payments" are not deductible, we do not believe, that there is a need for special tax provisions to curtail greenmail payments.

V. Summary

In conclusion, the current tax rules would not appear to be propelling the recent surge of corporate acquisitions and takeovers. We have set out in this testimony, however, certain aspects of current tax law that may encourage corporate acquisitions and that may be the proper subject of legislative reforms in this area. In particular, we look forward to working with your Committees this year to modify the rules relating to the carry over of corporate tax attributes in mergers and acquisitions. We do not believe, however, that Congress should amend the tax laws for the purpose of generally discouraging merger and acquisition transactions.

* * *

This concludes my prepared remarks. I would be happy to respond to your questions.

Chairman PICKLE. Mr. Olson, are you still with us?

Mr. Olson is vice president and associate general counsel of the Control Data Corp.

Mr. Olson, we are glad you can be with us today. We regret that we started out early this morning and now it is 3:30 p.m. and we are just now receiving your testimony. We know that you have been here a good portion of the time. We hope you have been able to listen to other witnesses.

We would be pleased to receive your statement. Do you have a written statement?

Mr. OLSON. Yes, I do.

I would appreciate it if it would be inserted in the record.

Chairman PICKLE. Before you proceed, I want to get a copy of that statement myself. Have you distributed that to the staff?

STATEMENT OF STEVEN J. OLSON, VICE PRESIDENT AND ASSOCIATE GENERAL COUNSEL, CONTROL DATA CORP.

Mr. OLSON. I have, Mr. Chairman. I realize the lateness of the hour, everybody is tired and there is an important basketball game this evening, so I will try to be very brief and summarize my statement.

I want to thank you for the opportunity to appear here today and commend you for spearheading this effort looking into how the tax laws have influenced, if not encouraged, the recent wave of hostile takeovers.

I would be remiss if I didn't take a few seconds at the outset to thank the members of the committee for Congress' passage last year of antitrust legislation to encourage joint research. Control Data was a catalyst in formation of a company called MCC located in Austin, TX, and we are appreciative of the chairman's efforts in passing this legislation.

MCC now has 21 members and we think this is a prime example of how Congress can encourage companies to cooperate together rather than feed on each other.

For almost two decades, Control Data's management has been very concerned about the profoundly negative impacts of hostile takeovers on the economic and societal health of the United States. U.S. tax laws have historically sought to encourage activity believed desirable and to discourage activities thought undesirable, so the initial question is whether hostile takeovers constitute the sort of activity to be discouraged or encouraged or whether the tax law should be structured so as to be neutral.

Control Data is in the camp that believes the actual or potential damage caused by hostile takeovers far outweighs theoretical benefits. A number of pages are devoted in the statement to that effect and follow closely the points made this morning by the three Senators.

First, concern over the massive debt indigenous to such transactions and the impact that has on future company operations. The current crisis in the American farm economy is perhaps eloquent testimony to the type of damage that can come about by excessive leveraging. We hardly need to repeat that in other sectors of the economy.

Second, the concern about short-term focus of managers. There is more to it than simply short-term focus. Companies today are spending large amounts of money and investing the time and ability of some of their most talented people playing war games and constructing elaborate defenses in anticipation of a fight for their corporate independence.

There probably is not a publicly held company in the country that has not made and is not making crucial decisions about what to keep, what to sell, what to spend on—or invest in—without its best independent judgment being bent to some degree by external takeover considerations.

These kinds of influences are economywide. They are not just limited to people who are participating in the takeover game.

Third, in specific transactions, there is frequently transactional fallout where employees, customers suppliers, and entire communities are severely disrupted. Too often the debate has tended to focus on the rights of shareholders. Increasingly society at large has a very large stake in this.

A word or two about so-called incompetent management.

Takeover advocates put great stock in the contention that tender offers protect the shareholders of the target and are needed as a discipline on incompetent management.

This contention assumes three premises, none of which happen to be borne out by the facts; that management of targets are indeed incompentent; second, that the persons replacing them will be more competent or they will in fact operate the company at all; and, third, that the performance of companies and the economy in general will be enhanced by threatened or actual takeovers.

Experience has shown that: First, takeover attempts are seldom made on targets with anything but extremely capable management; that many of those in the takeover game have neither experience nor have any real intention of operating the businesses they are pursuing or that they could; and finally, there is evidence that the economy during this era of active hostile takeover activity has in fact declined in performance at least when measured in terms of productivity.

But even if there were some evidence that these hostile takeovers were serving to check incompetent behavior, it doesn't follow that we should ignore the downside. Certainly the Jesse James gang also kept business management on its toes, but we hardly rewarded the behavior.

The fundamental point, however, is that the arguments of those people who support hostile takeovers are irrelevant. Nobody is advocating the absolute prohibition of hostile takeovers. Nobody is advocating that the Government intervene to the point of blessing or disapproving of any particular transactions. The question is whether enlightened Government policy can be devised which will eliminate the devastating fallout from such activities and still permit takeovers to take place.

So what can Congress do? Though it is not within this committee's jurisdiction, the most effective solution would be to amend the Williams Act, the law which now inadequately governs tender offers. That approach is suggested—and was this morning by Senators Chafee and Proxmire—in legislation introduced by them and,

in the House, by Congressman Markey. We do endorse the approach put forward by Senators Chafee and Proxmire because it would not prohibit takeovers, but would encourage rationale economic action and preclude the coercive and abusive tactics that characterize today's activities.

So how about the tax laws which are the central focus of this hearing? Mr. Chairman, we would favor legislation which would end subsidies of hostile takeovers currently embodied in our tax laws. These laws reward bidders by permitting the interest on debt borrowed to finance hostile takeovers to be deducted and by allowing acquired assets to be depreciated from a higher base. Thus, in principle, we strongly support the intent embodied in H.R. 1003 and H.R. 1100, both of which have been introduced by Congressman Jones.

Even those that would endorse the economics of hostile takeovers should not object to measures that would place the Government in the position of financial neutrality in the context of a hostile takeover battle. Under current law, the Government has taken sides. It subsidizes and rewards hostile bidders while no comparable tools are available to targets.

Finally, a few specific comments concerning these two bills.

First, we are convinced with respect to greenmail that the abuses in the payment of greenmail are being and will continue to be checked. To the extent that greenmail survives, however, we are concerned that imposing an excise tax on greenmail profits may have the perverse effect of simply causing the price of greenmail to go up, which would inflict greater injury on targets and the shareholders who remain. That is, the tax will simply be passed on to the consumer.

But we strongly endorse legislation to deny deductibility of interest incurred in connection with borrowing for hostile takeovers. Unlike the greenmail proposal, that proposal addresses the abuse of a subsidy which already exists in the Internal Revenue Code.

We urge the committee to also preclude a hostile purchaser from stepping up the basis of a target corporation's assets for purposes of depreciation and amortization unless the step up is recaptured and taxed in its entirety. Provisions to this effect are included in H.R. 1003.

This is a particularly graphic example of a legislative lack of neutrality between a bidder and target. It is impossible for a target to unilaterally step up the basis of its assets. A successful bidder, on the other hand, qualifies automatically and uses the increased cash-flow to fund that and future attacks.

Control Data urges that H.R. 1003 be amended to also disallow an increase in basis by reason of the tax paid on the step up. S. 632 includes such a provision and to preclude evasion the committee might consider denying a step up for any acquisition of shares made by a party subsequent to a hostile offer rather than only purchases "pursuant to" a hostile offer.

Finally, the committee might want to examine imposing taxes perhaps—waivable upon the expiration of a minimum holding periods—on pension funds or other large nonprofit institutional investors to get at the short-term incentives and focus of money managers. As such holders have come to dominate the markets, the salu-

tory effects of imposing minimal holding periods for capital gains treatment envisioned by Congress have been usurped.

In summary, as to the role of our Nation's tax laws on the hostile takeover environment, Congress need not even decide whether hostile takeovers are good or bad for the economy. It can simply adopt a posture of neutrality. But present law subsidizes bidders—and that must be stopped.

I would be happy to answer any of your questions.

[The prepared statement follows:]

STATEMENT OF STEVEN J. OLSON, VICE PRESIDENT AND ASSOCIATE GENERAL COUNSEL, CONTROL DATA CORP.

1. Introduction

My name is Steven J. Olson, and I am a vice president and associate general counsel of Control Data Corporation, which is headquartered in Minneapolis, Minnesota.

I want to thank you for the opportunity to be here today, and to commend you for spearheading Congress' investigation into the extent to which the tax laws have influenced (if not encouraged) the recent wave of hostile takeovers that has come to dominate the business pages of our Nation's newspapers.

For almost two decades, the top management of Control Data has been publicly voicing its alarm about the profoundly negative impacts of hostile takeovers on the economic and societal health of the United States. We are encouraged that others have begun to share this alarm—as evidenced by this and several other recently held or scheduled congressional hearings.

2. The Role and Impact of Takeovers

As this committee knows, U.S. tax laws have historically sought to serve many ends in addition to raising revenue. Irrespective of debates about the general wisdom of this approach, our country always has (and probably always will) used its tax policies to encourage activity believed desirable and to discourage activities thought undesirable—whether over the near or long term. Thus, as with any other issue, an initial question is whether hostile takeovers constitute the sort of activity to be encouraged or discouraged, or whether tax laws should be simply structured so as to be "neutral."

Parties who are interested in or have studied the takeover phenomena fall, not surprisingly, into two distinct camps. Control Data is decidedly in the camp that the actual or potential harm caused by hostile takeovers—or by an environment that encourages hostile takeovers—far outweighs any actual or theoretical benefits, most of which can be and are achieved through other mechanisms. Among our major concerns:

A. MISUSE OF CAPITAL

Takeover attempts and defenses not only soak up a limited Resource—capital—but, of perhaps greater importance, the massive debt indigenous to such transactions can cripple the ability of companies to grow, prosper and compete in the future or, in extreme cases, to even survive. As Securities and Exchange Commission Chairman, John Shad, has pointed out:

"Corporate takeovers and buyouts are financed through large loans. The net effect is that debt is being used to retire equity, which is known as leveraging up a company's capitalization. The greater the leverage, the greater the risks to the company, its shareholders, creditors, officers, employees, suppliers, customers, and others * * * the more leveraged takeovers and buyouts today, the more bankruptcies tomorow * * * the leveraging up of American enterprise will magnify the adverse consequences of the next recession or significant rise in interest rates."

Nor is this concern just theoretical. Recent examples of targets who must now service mountains of debt include Phillips Petroleum, Continental Group, and Twentieth Century Fox Film Corp. And while a few shareholders may have profited handsomely, the ability of these and other firms similarly situated to survive the next economic downturn—and all that portends for their employees and other constituencies—has been unquestionably jeopardized.

I might add, Mr. Chairman, that the current crisis in the entire American farm economy is perhaps the most eloquent testimony there is as to the economic and human tragedy that can result from excessive leveraging. We hardly need a repeat in other sectors.

B. STRATEGIC DISTORTION

As companies strive to avoid becoming targets—to push share prices continuously upward—management attention is riveted to short-term results. As Peter Drucker has said:

"A good many experienced business leaders I know now hold takeover fear to be a main cause of the decline in America's competitive strength in the world economy * * * it contributes to the obsession with the short-term and the slighting of tomorrow in research, product development, and marketing, and in quality and service—all to squeeze out a few more dollars in the next quarter's "bottom line".

But there is more to it than simply a short-term focus. Companies spend large sums of money and invest the time and ability of some of their most talented people playing war games and constructing elaborate defenses in anticipation of a fight for corporate independence; there probably is not a publicly-held company in the country that has not made and is not making crucial decisions about what to keep, what to sell, what ot spend on—or invest in—without its best independent judgement being bent to some degree by external takeover considerations; and managerial values, as well as those of the cream of our youth, have become distored as pirates become folk heroes to be admired and emulated, with headlines focused on people who put together syndications to reallocate existing wealth rather than those that create new wealth. While distortions such as these are difficult to measure, I assure you they exist—and their impact is economy-wide; it is not limited to participants in the hostile takeover game.

C. TRANSACTIONAL FALLOUT

In specific transactions, there is frequently transactions fallout, where long standing relationshsips with suppliers, customers, employees and communities are severely disrupted. It's not just plant closings and the firing of "duplicative" managers—as traumatic as that can be to those directly involved. The local presence of an independent firm involves irreplaceable intangibles beyond its direct payroll. Charities, the arts, educational, civic and governmental organizations are only the most obvious examples of "quality of life" institutions that receive one level of support when a firm is directly committed to a community and another when it is not.

All too often the debate over hositle takeovers has focused on the rights of shareholders; we must not lose sight of the fact that, increasingly, society at large has a stake.

D. THE "ENTRENCHED MANAGEMENT" FALLACY

Advocates for hostile takeovers include those active in the game, such as arbitrageurs, as well as economists of the so-called "Chicago school." They contend that hostile takeovers are simply a preferred free-market mechanism whereby our society's resources are allocated to their best and most efficient use—in other words, predation is nature's way. Many espouse this view as consistent with an emphasis on "deregulation." It is not, of course, but it sounds good. True deregulation requires a context wherein people are in a position to make informed, rational, unhurried and uncoerced choices; a market that flourishes on ignorance, surprise and "offers that can't be refused" is free only in a barbaric sense.

Takeover advocates also put great stock in the contention that tender offers protect the shareholders of the target, and are needed as a discipline on incompetent management. As pointed out above, however, the current ease with which takeovers occur in fact pressures management to behave incompetently. Moreover, such a contention assumes at least three premises, none of which appear to be borne out by the facts: (1) That management of targets are indeed incompetent; (2) That the persons replacing them are more competent (and will in fact operate the company); and (3) That the performance of companies has been enhanced by threatened or actual takeovers. Experience has shown, however: that takeover attempts are seldom made on targets with anything but extremely capable management; that many of those most active in the takeover game have either no or minimal experience in operating businesses similar in size or activities to the target; and that performance may well have declined. As Professor F. M. Scherer of Swarthmore College recently pointed out in testimony before another congressional committee:

"If takeovers are an important disciplinary mechanism stimulating managerial efficiency, one might expect the rapid increase in takeover activity during the late 1960's and late 1970's to have been followed by improved over-all economic performance—e.g., on such dimensions as productivity growth. In fact, the annual growth of output per work hour in the economy's private nonfarm business sector declined from 2.6 percent over 1947–64 to 1.7 percent over 1964–74 to 1.4 percent over 1974–84."

Finally, even if there were some evidence that hostile takeovers served to check incompetent behavior, it does not follow that we should ignore the cost involved: No doubt the Jessie James gang also kept business management on its toes.

The fundamental point, however, is that advocates of hostile takeovers are relying on arguments that are irrelevant. No one is advocating the absolute prohibition of takeovers; that is simply a bogeyman of the defenders of the status quo. The question is whether enlightened Government policy can be devised which will eliminate the devastating fallout from such activities.

3. Why the Current "Wave" of Takeovers?

Last year was a banner year for "hostile takeovers." In the first nine months of 1984, as reported by the *Wall Street Journal*, mergers, divestitures and leveraged buyout transactions totaled more than $103 billion, an increase of $20 billion over comparable transactions for all of 1983. 1984 also saw an estimated $80–90 billion of equity securities removed from the marketplace by corporate repurchase, a good part of which was driven by takeover defensive action. This accelerating phenomenon appears to result from a combination of factors.

First, the stock market has substantially undervalued most companies in recent years. The truth of the saying that "exploring for oil on Wall Street is cheaper than drilling for new reserves" is certainly not limited to oil companies.

Second, the stock market has become increasingly dominated by institutional investors, whose focus is this quarter's results. A premium—any premium—is readily gobbled up by "shareholders" whose modus operandi is temporarily parking funds rather than investing for the long haul.

Third, there seems to be an endless supply of easy money available for hostile bids—whether through bank loans or the latest junk bonds, and whether to established firms or neophytes. In one recent hostile bid for a Minnesota company, the bidder had a net worth of $43,000 in June, raised $2 million in a public offering in July, lined up a $10 million line of credit in August, and launched a takeover bid in September for an established computer services company worth $12 million.

Fourth, our tax laws subsidize hostile bids by permitting the interest on debt borrowed to finance takeovers to be deducted, and allowing acquired assets to be depreciated from a higher base. Edgar M. Bronfman, the chairman and chief executive officer of Seagrams has pointed out the folly in forcing the average taxpayer to be indirectly footing the bill for a significant part of corporate takeover games, a particularly peculiar and unwarranted governmental intervention in the context of the current laissez-faire economic trend.

Finally, the government regulatory framework for hostile takeovers—the Williams Act—has failed to accomplish its initial purpose—the assurance of a "level playing field" to takeover combatants. The fact that four out of five companies "put in play" do not emerge unscathed belies any such characterization.

Government policies, or the lack thereof, can have a profound impact on each one of these factors. For example, Federal deficits and the strong dollar certainly bear upon the deflated stock market value of American firms. But I would like to conclude my remarks by focusing on the two factors that could be most directly remedied.

4. Recommended Solutions

A. WILLIAMS ACT

There are a variety of ways to curb some of the abuses and undesirable effects inherent in today's hostile takeover environment. Though not within this committee's jurisdiction one of these is to amend the Williams Act, the law which now inadequately governs tender offer. That approach is suggested in legislation which has been introduced during this session in the House by Congressman Markey (H.R. 1480) and in the Senate by Senators Chafee (S. 631) and Proxmire (S. 706). While the details of the approaches taken in these proposals may differ, they share a common objective: Ensuring informed and deliberate decision-making by individuals in a po-

sition to focus on both the short and long-range implications of any particular takeover proposal. Thus, each of these bills:

(1) Provides for increased disclosure as to the bidder's goals and business plans with respect to the target, and the anticipated effects of such actions on the bidder and target, as well as upon their respective shareholders, employees, creditors, suppliers, customers and the communities in which either operates;

(2) Puts in place an approval process whereby outside directors and/or shareholders of both the bidder and target companies would each approve any particular takeover before it could be consummated; and

(3) Extends the minimum offering period during which a takeover offer must remain open, in order that shareholders and other constituencies have an adequate time to weigh the information with which they will be provided and to ensure that the mechanical processes of approval can be accommodated.

Control Data strongly endorses this sort of comprehensive approach. It does not prohibit hostile takeovers; it encourages rational economic action, and effectively would preclude the coercive and destructive tactics that characterize today's environment.

B. INTERNAL REVENUE CODE

Control Data also favors legislation which would end the senseless subsidization of hostile takeovers currently embodied in our tax laws. These provisions reward bidders by permitting the interest on debt borrowed to finance hostile takeovers to be deducted and by allowing acquired assets to be depreciated from a higher base. Thus, in principle, we strongly support the intent embodied in H.R. 1003 and H.R. 1100—both of which have been introduced by Representative Jones.

Even those of the "Chicago school" should not object to measures that would place the Government in a position of financial "neutrality" in the context of a hostile takeover battle. Under current law, the Government has taken sides: It subsidizes and rewards hostile bidders, but no comparable tools are available to targets.

Although Control Data has no experience when it comes to hostile takeovers, our experience in other transactions confirms what I am sure any witness must confirm: Whether a deal is made or not made is often dictated by the tax ramifications. While that is justifiable in the context of negotiated, consensual business transactions, it should not be allowed to be a factor—particularly a determining factor—during battles among firms at war for corporate control. This is particularly true where the government subsidy is also encouraging the substitution of debt for equity—the so-called "leveraging up" which SEC Chairman Shad has alluded to. Under such circumstances, the economics of equity—not debt—should apply.

Finally, a few specific comments concerning H.R. 1003 and H.R. 1100.

(1) Excise tax on greenmail profits

However egregious the payment of greenmail may be—and Control Data agrees that the practice is contemptible—the fact is that in some situations the payment of "greenmail" may be the only remaining option for a target that wants to remain independent. We are reluctant, for a variety of reasons, to impinge on the right of a target to avail itself of that option. First, we are convinced that abuses in the payment of greenmail are bing and will continue to be checked through appropriate application by State courts of the business judgment rule. (Indeed, as reported in the *Wall Steeet Journal* on March 28, 1985, many companies are in the process of adopting anti-greenmail charter amendments). Second, the chief beneficiaries of anti-greenmail legislation are the arbitrageurs, and we are reluctant to endorse any step that will reduce their risks and thereby encourage the expansion of their activities—in numbers or involvement—in securities markets. Third, we suspect that imposing an excise tax on greenmail profits may have the perverse effect of simply causing the price of greenmail to go up, inflicting greater injury on targets and shareholders who remain—that is, the tax will "merely be passed on to the consumer." And finally, as can happen so often when what is essentially a non-tax problem is addressed via a tax remedy, there is substantial risk that—whether through inadvertence or the fertile imagination of tax practitioners—the remedy will "miss" activity which should be covered and "hit" activity that should not.

In connection with this last point, I am advised that tax practitioners working with the recently enacted tax legislation concerning golden parachutes have encountered many such situations. So too, potentially, with greenmail. For example, H.R. 1100, as now drafted, would exempt profits on sales by "four-percent shareholders" who had held their stock for a year. But a perfectly "innocent" four-percent shareholder—in the sense that the investor may have had nothing to do with any takeov-

er offer—would be trapped by the tax if the investor had happened to buy shares less then a year before a company was taken over by someone else—and, even if the takeover failed, such an investor would be locked in for at least a year, unable to even sell on the open market without incurring the tax. Conversely, a takeover artist could, for example, buy a 4.9 percent of a company, sit on it for a year (or theoretically only ten months), mount a hostile takeover, and be greenmailed-out so long as the sale occurred more than one year after the stake was acquired. If a non-tax practitioner can devise such not-so-hypothetical scenarios, I shudder to think about the schemes that will jump to the mind of tax professionals.

(2) Interest on hostile acquisition indebteness

Control Data strongly supports legislation to deny deductibility of interest incurred in connection with borrowing for hostile takeovers. Unlike the proposal dealing with greenmail, such a proposal addresses the perverse abuse of a subsidy which already exists in the Internal Revenue Code. (Of course, the efficacy of any change will be limited, in that it would have no bearing on hostile takeovers involving the exchange of securities).

Specifically with respect to H.R. 1100, to the extent that section 2 is aimed solely at "junk bonds," we would urge that the bill be expanded to include bank loans or any other hostile-acquisition related indebtedness (and, as an alternative approach to the greenmail problem, perhaps include debt incurred by a target to pay greenmail). In this connection, we also suggest that the 20 percent threshold for disallowance of interest deductibility be lowered.

(3) Stepped-up basis of acquired assets

We urge the the committee also preclude a hostile purchaser from stepping up the basis of a target corporation's assets for purposes of depreciation and amortization unless the step-up is recaptured and taxed. Provisions to this effect—amending sections 337-338 of the IRC—is included in H.R. 1003 and has been introduced in the Senate by Senator Chafee (S. 632).

This is a particularly graphic example of a legislative lack of "neutrality" between the bidder and target. It is impossible for a target to unilaterally step-up the basis of its assets; a successful bidder, on the other hand, qualifies automatically, and uses the increased cash flow to fund its attacks.

As a "technical" comment, Control Data would urge that H.R. 1003 be amended to also disallow an increase in basis by reason of the tax paid on the step-up. S. 632 includes such a provision. Also, to preclude evasion, the committee might consider denying a step-up for any acquisition made by a party which has previously made a hostile offer, rather than only purchases made pursuant to a hostile offer.

(4) Another aspect of existing law that facilitates takeovers

Finally, the committee might want to examine imposing taxes, perhaps waivable upon the expiration of minimum holding periods, on pension funds or other large "non-profit" institutional investors—to get at the short-term incentives and focus of money managers. As such holders have come to dominate the markets, the salutary effects of imposing minimal holding periods for capital gains treatment envisioned by Congress have been usurped.

In summary, as to the role of our Nation's tax laws on the hostile takeover environment, Congress need not even decide whether hostile takeovers are "good" or "bad" for the economy. It can simply adopt a posture of neutrality. But present law subsidizes bidders—and that must be stopped. Nor should we delude ourselves into believing that an end to tax subsidies is a cure-all. That will require a more direct and comprehensive approach.

5. Conclusion

Proponents of the status quo as regards hostile takeovers assume a mantle of indignation whenever anyone suggests some modification to the rules. They talk about "incompetent management" and the sanctity of "efficient capital market" hypotheses. They also operate from the premise—since it suits their purpose—that any proposal, however modest, equates to a "prohibition" of hostile takeovers.

Mr. Chairman, I readily acknowledge that under our economic system, the existence of a takeover mechanism has a role to play. But that role is being abused. The contention that any executive that resists a takeover is "incompetent" whereas people in pursuit are simply "efficiently allocating resources" is a smokescreen. In the real world, competently managed companies are the prime targets, and they are the targets of individuals more often driven by greed and ego than economics.

Today's hostile takeover environment exaggerates an already too great focus on short-term performance; it rewards the simple rearranging of assets; above all, it shifts attention from the development and production of products, the creation and retention of jobs, and the increasing challenge from international competitors—concerns which should be the top priority of our Nation and our managers.

Thank you. I'd be happy to respond to any questions or comments you might have.

Chairman PICKLE. You certainly have given a lot of information and you have done it in a rapid fire manner, too, Mr. Olson. I would have been happy if you would have gone slower because you are the first witness today who has taken a very strong position as a company which is involved.

Let me ask you: Is Control Data a target company now? Is it subject to being taken over or do you know?

Mr. OLSON. Only in the sense that I think every company currently operating in the country is a target. As far as I know there are no particular individuals or companies that are actively after us at this point, but certainly any company—if you look at what has happened to Gulf and Phillips and companies of that size—is a potential target in this day and age.

Chairman PICKLE. I had read in the Wall Street Journal from 2 or 3 days ago that you might have become a target company, that you are also taking steps to try to ward off such a development, particularly by the espousal of some kind of a plan where your executives could buy stock on a loan basis and perhaps not have to pay it back and not have to pay any income tax on it.

Mr. OLSON. They certainly have to pay income tax on it, I believe. The objective of that plan really had nothing to do with takeovers. It is more of an incentive plan for management whereby if the company performs well, they perform very well and are rewarded with stock. Certainly any forgiveness of debt would be taxable to the executives involved.

Chairman PICKLE. How old is Control Data?

Mr. OLSON. Control Data was founded in 1957. William Norris, our founder, and five other people, raised $600,000. Today, roughly 25 years later, we have something in excess of 50,000 employees and revenues in the $5 billion range.

Chairman PICKLE. You are certainly one of the leading companies in America and Mr. Norris is one of the leading authorities in the high technology field, national or international, and so your statement has a special meaning to me when you say very strongly that Control Data strongly supports legislation to deny deductibility of interest incurred in connection with borrowing for hostile takeovers.

Do you have a definition of what would be a hostile takeover?

Mr. OLSON. Well, certainly I think that traditionally hostile is cast in terms of whether the management of the target supports the bid for the company or not. The problem with that is that management of the target can be accused of simply trying to protect their employment position and not have the interests of shareholders or other constituencies closest on their mind.

I believe Mr. Jones is attempting to take away that decision from the management of the target and invest it in the hands of independent directors, people not directly connected with working as

employees of the company, so they are theoretically at least not protecting their own skin.

I know there have been several questions directed at that. It seem to me that Congressman Jones' proposal will encourage companies to take on independent directors because without independent directors—presumably if Congress should act and deny deductibility or a step-up in basis, if disapproved by independent directors—the corrollary to that is if there are no independent directors, automatically the bidder will get the deduction and the step up, to so should encourage companies to take on independent directors.

These independent directors do not operate in a vacuum. They, too, are fiduciaries and will have to look seriously at any bid, whether it is in the interest of their shareholders. They can't just arbitrarily reject a bid. It seems to me that would be our preferred definition of hostility also.

Chairman PICKLE. We are not trying to decide on a bill and the hearing today is not with reference to the Jones-Boren bill or the Proxmire bill or any other approach. We may or may not become interested in that. What we are trying to get is a lot of facts and information on the table.

Now, if by way of your company's case, if there were an effort to takeover, would it be by a conglomerate or an amalgamation of companies or individuals who were familiar with the general high tech business? Do you know?

Mr. OLSON. I really—anything I might say on that would be rank speculation, Mr. Chairman. I would have no idea who might——

Chairman PICKLE. You said earlier that the general assumption was that management was lazy and that they are fat and that they need to get somebody in that knows what they are doing. That doesn't necessarily follow because they may not be capable of running the company.

Mr. OLSON. That is true. Nobody is suggesting that you preclude those kinds of managements to be thrown out.

Chairman PICKLE. Why would someone be interested in taking over Control Data?

Mr. OLSON. Currently our stock is very depressed, we believe, significantly below its true worth. That would be one reason they may. We think we are an innovative company. That may be attractive to some. But I don't want to come up with reasons why somebody might come after us.

Chairman PICKLE. I presume that a low valuation of stock might be a signal. It is in other cases, but that alone wouldn't be enough, particularly for a company that has been going on for 25 years or more.

Mr. OLSON. Well, I suspect Gulf Oil is probably 60 years old, or Phillips. I don't know that the age of the company is particularly determinative one way or another.

Chairman PICKLE. Mr. Anthony, do you have questions of Mr. Olson?

Mr. ANTHONY. Thank you, Mr. Chairman.

I was curious and you were nibbling around on the fringes of it, about the tax attributes of a company similarly situated as Control Data. Could you analyze that for us? In your line of business, not necessarily going 100 percent to Control Data, what would be the

type of tax attributes that an acquiring company would look at to say that you are a targeted company?

Mr. OLSON. Currently we don't have any accumulated losses they would like to come after. I am not—I couldn't comment in a gross way as to the tax bases of any assets that we are depreciating as to whether there is some potential for somebody being able to come in and take over the company and thereby pay for it through cash flow. I don't think there is anything particularly in our operation that is attractive from a tax standpoint in the way, the type of business that we are in, that would be comparable, for example, to the oil industry or something like that.

You wouldn't be buying the kinds of assets that are involved there. So that is why our concern is principally, I guess, in the deductibility of interest. That is certainly an important one to me because obviously if Carl Icahn is going to go out and borrow $5 billion or something to buy Phillips, he is going to do it with fairly junior debt, so 15-percent interest rates aren'ts unreasonable.

You are talking about a $750 million a year interest bill, and if the Government is willing to pick up $300 million or $400 million of that for him, I am sure it makes him a far more able bidder.

Mr. ANTHONY. If we were asked to deny the deductibility of debt on a hostile takeover, why should we not extend that to all mergers and acquisitions?

Mr. OLSON. Several have asked that question. I think there is a vast difference between the two. Certainly in the case of a negotiated transaction where both parties have looked at the deal, said this is good for all constituencies involved, they then negotiate the terms of the deal and any tax benefits or detriments are shared between them. They can adjust the price or do whatever they want on a negotiated basis and the tax benefit as it were falls wherever they want to put it. In a hostile situation, it is a one-way street.

Mr. ANTHONY. In regard to some very large agreed-upon acquisitions, I can go back and read where they incurred a huge debt. In order to service that debt, they had to start spinning off assets so the debt would be lowered. That enabled them to service the debt within the terms of the existing corporation. It seems to me that those types of friendly mergers create the same consequence of a hostile takeover. This gives the company heartburn by trying to figure out how to carry that debt. It has already been stated by many people, such as one of the big raiders in Minneapolis. He went after ITT saying that the sum of the parts are worth more than the whole. He is talking to them right now about spinning off some of those assets.

Look at another food company, for instance, that merged and bought a much larger company than they were originally. As a result, they have incurred a huge amount of debt, and now they are in the process of spinning off asset after asset.

It appears to me that some of these things, even if friendly, create the identical type of circumstances that a hostile one does. In other words, you have two people that want to do it versus a board saying it is good. If we don't worry about the decisionmaking process but look at the effects of what the decision is we don't know whether it is hostile or friendly and we just look at the arith-

metic of what is created, then why shouldn't we do it on one and not the other? It bothers me.

Mr. OLSON. It bothers us, too. We would say that in a friendly situation, there is at least the check in there of the target—the target entity having a sayso, having looked at the transaction and determining that it does make economic sense, whereas in the hostile situation, they have concluded that it does not, and yet the Government proceeds to subsidize the bid.

Mr. ANTHONY. Through the Tax Code.

Mr. OLSON. The thing that your comment underlines also is perhaps the fact that the tax laws certainly alone are not going to solve this problem. What is needed is something in the process whereby information is gotten to shareholders, additional time is provided to shareholders, additional rationality, and collective decisionmaking by shareholders is brought into the process.

Mr. ANTHONY. I would like to call your attention to page 10 of your testimony. I wonder whether or not you could furnish us more specific information about this case, if the staff does not already have it. I can tell you that this is something that will make the hair on the back of your neck rise.

I represent a lot of farmers that would like to start planting cotton, soybeans, and rice. They are being told that there is a credit crunch out there and they aren't able to receive any credit. If you are correct, and if there are not other extenuating circumstances of underlying collateral such that the debt could be more collateralized than the case example you mentioned, then are you talking about a company that has a net worth of $43,000 and is able to go out and create $12 million in debt financing?

Mr. OLSON. That is correct.

Mr. ANTHONY. If that is true, I wish you would give me the name of the company. I have about 400 farmers in Arkansas. They have $50,000 of net worth and they only need $400,000 worth of debt financing. Maybe we can solve the problem of our farmers just by finding out what company is willing to get into this situation.

I am serious about you providing additional facts, Mr. Olson.

Mr. OLSON. I would be happy to.

[The information follows:]

Congressman Anthony has requested "additional facts" concerning the transaction described on page 10 of my statement—the tender offer by Edudata for shares of Scientific Computers wherein Edudata, with a net worth of $43,000, was successful in raising $2 million for the bid. To correct the record, my testimony affirming that the "deal went through" was wrong. Instead, Scientific Computers, which had little debt and a cash reserve of $3.7 million before the raid, bought back Edudata's stake for $6.4 million (plus $500,000 in attorneys' fees) by borrowing $4 million and taking the remainder from cash reserves. Thus Scientific Computers remained (and remains) independent, but in a substantially weakened condition.

As for background on the Edudata/Scientific Computers transaction, I would bring to the Committee's attention the following quotations from the decision of the Commissioner, Minnesota Department of Commerce, in his decision, "In the Matter of the Registration of Edudata Corporation, a Delaware Corporation.":

(1) "S.C.I., is a Minnetonka, Minnesota based public issue corporation engaged in on-line data processing service and graphic art. The Company employs approximately 250 people, and has its authorized stock at 10 cents par value . . . As of the third quarter of 1984, the stock was selling at a high of $12 per share and a low of $9 per share. The Company's financial statements as of March 31, 1984, indicate total assets of approximately $12,857,328 and total liabilities and long-term debt of $2,760,648."

(2) "Edudata's net worth in July [1984] was $43,412. While it is difficult to decipher the exact makeup of Edudata's fixed assets, they were believed to be basically composed of approximately six Apple personal computers and six IBM personal computers. During the first nine months ending April, 1984, the corporation earned $17,900 in tuition, but sustained $201,000 in expenses, thus incurring a $184,000 loss. . . . On July 27, Edudata went public and on August 7, 1984, received about $2,265,000 by sale of 18 percent of its stock. The remaining 82 percent of its stock was held by "Sun" [Equities] and others, whose total consideration for the stock was $248,250."

(3) "Less than 75 days ago, Edudata had a net worth of $43,000. Its assets were basically a few personal computers and accompanying software. Its nine month gross earnings for March were $17,000, offset by expenses of $201,000. Over 50 percent of these expenses were apparently the salary and compensation to its President. The company has only three full-time employees, none of which have any experience in computers, data processing, systems design, programming, or even in teaching. None have experience in the management of companies. None are even remotely connected to the clientele, vendors, or service area of the Target corporation. As noted by Ms. Koether [President of Edudata], the Company was basically inactive until this year. Yet, at that point, Edudata then went public, raising $2.2 million in July, stating that it will go into the business of computer training. Withing three weeks, however, it took the funds and, borrowing $10 million from a bank [the Howard Savings Bank of New Jersey], offered to buy the S.C.I. stock. It pledged S.C.I. property as collateral, apparently agreeing upon an eventual merger, to pay the bank any cash held by S.C.I. over $300,000."

Mr. ANTHONY. I would like to analyze that situation closely. I think it would benefit the record.

Mr. OLSON. The bidding company was a company called Edudata and the target was a Minnesota company called Scientific Computers.

Mr. ANTHONY. Did the deal go through?

Mr. OLSON. Ultimately, yes. It was fought in the courts and fought in a variety of ways——

Mr. ANTHONY. Is this a recent example?

Mr. OLSON. I would say it was last fall. I would be happy to provide you——

Mr. ANTHONY. This member would like to have that information. If the chairman thinks it would improve the record, we can have it submitted.

Mr. Chairman, I yield back the balance of my time.

Chairman PICKLE. Thank you, Mr. Anthony.

Mr. McGrath.

Mr. MCGRATH. Mr. Chairman, I have no questions.

Chairman PICKLE. Mr. Olson, your company has grown and prospered and you have done a little acquiring of your own over a period of time.

Mr. OLSON. Yes, we have, never, I might add, in a hostile acquisition.

Chairman PICKLE. Has your firm used junk bonds to raise capital for these acquisitions?

Mr. OLSON. Not to my knowledge.

Chairman PICKLE. Should interest payments on junk bonds be deductible when used in acquisitions?

Mr. OLSON. I believe, as I stated in my testimony, Mr. Chairman, we would draw a distinction between the hostile and the nonhostile situation. No, they should not in the former.

Chairman PICKLE. In regard to your company, either as a target firm or as an acquiring firm, has the existence of these nonopera-

ting losses affected your decisions in making your decisions? In making your decisions, has NOL's played a part?

Mr. OLSON. I don't think so. There may have been situations when we acquired some or all of a company with a net loss carry forward——

Chairman PICKLE. Have you been involved with the greenmail?

Mr. OLSON. No.

Chairman PICKLE. Has your firm made greenmail payments?

Mr. OLSON. No.

Chairman PICKLE. You haven't had any experience with the greenmail?

Mr. OLSON. None whatsoever.

Chairman PICKLE. Now, do you feel that the tax laws—our present tax laws, encourage these mergers?

Mr. OLSON. I would be hesitant to say that they are the prime motivator in very many mergers, but certainly there are a whole variety of business considerations that enter into whether a deal is made or not. You always have your tax lawyer at your side and certainly the tax outcome can tip the decision one way or another if you go forward.

Certainly, as I cited earlier, the Phillips acquisition, my guess would be if the interest on the debt there were not going to be deducted, it could have had a profound impact on whether or not that transaction was attempted.

Chairman PICKLE. Some experts—and you alluded to this next question--some experts explain that their firm is vulnerable to a takeover when the stock is undervalued in relation to its underlying assets, and your stock is a little low now, you say?

Mr. OLSON. Yes.

Chairman PICKLE. Second, that the corporation has a high Federal tax liability; and three, the corporation has large cash assets, including perhaps, an overfunded pension plan. To what extent did any of these factors figure into your corporate merger activities in the past, or as you face it now?

Mr. OLSON. I don't think they have in any acquisitions we have been involved in one way or the other. Certainly I believe our pension funds are overfunded at this point and we do have some assets which may make easy divestitures to raise cash and so forth, so I would guess we have the normal concerns that any company would.

Chairman PICKLE. Has your company been involved in the installment sales procurement?

Mr. OLSON. Not to my knowledge.

Chairman PICKLE. The companies you have acquired, are they largely in the generally related areas of technology?

Mr. OLSON. Certainly, today—we made one large acquisition 15, 17 years ago of a finance company, Commercial Credit Co., other than that I believe they all have been.

Chairman PICKLE. Your company today has how many employees, Mr. Olson?

Mr. OLSON. My best guess would be about 50,000, Mr. Chairman.

Chairman PICKLE. Are you seeking any kind of a takeover or a merger with somebody?

Mr. OLSON. No, we are not.

Chairman PICKLE. You want to be let alone?

Mr. OLSON. Yes, we do, indeed.

Chairman PICKLE. Can I make that as an official announcement to all corporate America?

Mr. OLSON. I think our chairman has done that on several occasions.

Chairman PICKLE. I notice that he has and I am glad he has spoken out on the question. It may be that as we proceed we might extend a further invitation to you, depending on developments, to appear before us and make additional statements.

Mr. ANTHONY. Mr. Chairman, I do have one pet question I would like to ask before you close.

Chairman PICKLE. I yield to you, Mr. Anthony.

Mr. ANTHONY. Concerning ESOP's, I was curious as to what your history has been with them. Have you utilized them, and have you any concerns?

Mr. OLSON. I was asking someone who was here with me today what they knew about our ESOP's. I know we have an ESOP and that we all get some infinitesimal number of shares, but that is really the extent of my involvement with our current ESOP plan.

Mr. ANTHONY. Would you do me a favor and go back and if you find that there are any unusual problems with utilizing ESOP's, especially in light of the 1984 changes. If you have any additions to your statement—regarding what you find—submit those in written form for the record.

Mr. OLSON. I would be happy to.

[The information follows:]

Congressman Anthony has requested additional comments concerning "any unusual problems with utilizing ESOPs, especially in light of the 1984 changes". To correct the record, my testimony that Control Data has an ESOP was incorrect. Instead, Control Data has a "PAYSOP" (a payroll based tax credit stock ownership plan), contributions to which are of course limited to one-half percent of the participating employees' taxable compensation. As a result, we have no experience with ESOP's from which to comment on their potential problems.

Mr. ANTHONY. Thank you, Mr. Chairman.

Chairman PICKLE. I don't have any other questions.

We have written questions to submit to you and we would like you to respond as quickly as possible, if you would, Mr. Olson.

[The questions and answers follow:]

S.J. OLSON RESPONSES TO ADDITIONAL QUESTIONS POSED BY CHAIRMAN PICKLE

Question 1. Do you feel that the tax laws encourage mergers? If so, which provisions are primarily used by the parties involved in mergers? Should the tax code be neutral toward mergers? If yes, which provisions of the tax code should be changed and how?

Answer. Control Data believes that present tax laws subsidize hostile takeovers—particularly provisions that permit interest on debt borrowed to finance hostile takeovers to be deducted and that allow acquired assets to be redepreciated from a higher base. These "subsidies" should be eliminated and the tax code made neutral (see Testimony, pages 13-14, 17-19).

Question 2. Some experts argue that a firm is vulnerable to a takeover when (1) stock is undervalued in relation to its underlying assets; (2) the corporation has a high effective tax rate; or (3) the corporation has substantial liquid assets, including an overfunded pension plan. To what extent have any of these factors been involved in the merger activities of your company?

Answer. Control Data does not engage in hostile acquisitions. Any of the circumstances listed in the question can be relevant in the context of a particular merger,

as are many other factors. In Control Data's case, the overriding consideration in friendly transactions is the strategic fit of any particular business or technology.

Question 3. Some experts argue that the tax laws encourage debt financing rather than equity financing since corporations are allowed deductions for interest payments but not for payment of dividends.

(a) Do you agree?

(b) Should the Congress restrict or eliminate the deductibility of interest (1) generally; (2) in all mergers; (3) in "hostile takeovers;" or (4) for "junk bonds"? Please explain.

Answer. (a) Yes.

(b) Eliminating deductibility of interest generally involves consequences and considerations that go substantially beyond the current hostile takeover problem. As indicated in the Testimony before the Subcommittee, interest on debt incurred (whether "junk bonds" or other borrowings) for the purpose of engaging in a hostile takeover should not be deductible since this amounts to a governmental subsidy for the bidder and thus encourages such activity (see Testimony, pages 17–18).

Question 4. If a line were to be drawn for tax purposes between friendly mergers and hostile mergers, how should hostile be defined? Should a vote by the "independent directors" of the target corporation be determinative? If not, what test or standard should we use? Should the tax code distinguish between hostile and friendly mergers?

Answer. Control Data believes it is entirely appropriate to distinguish between friendly mergers and hostile takeovers, disallowing interest deductions as to the latter. Several proposals suggest a vote by "independent directors" as the distinguishing characteristic, which is entirely rational. Where a transaction is negotiated, the parties are able to mutually agree upon the allocation of any tax consequences in the context of the entire transaction; thus the government is not in the position of unfairly subsidizing one side over another. "Disinterested" or "independent" directors are the most logical choice to determine the nature of the transaction, since they are not in a conflict-of-interest position (as employee directors would be) and they are subject to a state-law imposed fiduciary duty to act responsibly. Alleged concerns over private parties being in a position to dictate tax consequences are overstated; private parties determine the tax consequences in thousands of transactions, by deciding how the transaction is structured in light of IRC requirements. This is no different.

Question 5. Have "junk bonds" been utilized in any mergers or attempted takeovers involving your company? If so, to what extent?

Answer. Not to my knowledge.

Question 6. Have junk bonds been used to raise capital by your company? If so, to what extent?

Answer. Not to my knowledge.

Question 7. If the deduction for interest payments on junk bonds were denied, do you feel that such denial should apply:

(a) To all junk bonds;

(b) To junk bonds used in connection with any merger or acquisition;

(c) To junk bonds used by any target company to repurchase its own stock?

Please explain your answer.

Answer. The principal thrust of any legislation should be to subparagraph (b) as applied to hostile takeovers. If it were extended to subparagraph (c), it should be limited to certain situations where the target company repurchase is in response to a hostile takeover attempt. Financing via "junk bonds" is not inherently evil, and is an entirely legitimate way to raise working capital, expand or recapitalize a business.

Question 8. When junk bonds are used by a potential acquiring company, is the security for that financing usually the assets of the target company? If the lenders look to the assets of the target, is there an expectation that certain assets will be sold to service the debt? What would the beneficial and detrimental results of such sales be?

Answer. Not infrequently, target companies are dismantled in order to reduce acquisition debt. This can be immensely detrimental in several ways. First, plants or facilities may be closed, resulting in losses of jobs and a "reverse multiplier" effect on communities and many other corporate constituencies. Second, in order to service the massive debt, companies often cut back on research and development, plant modernization, employee training, and other such "long-term" investments. This not only has serious implications for individual firms, but the entire economy and our ability to compete internationally suffers immeasurably. Control Data has urged that bidders be required to disclose their plans to dispose of assets or close plants

and the anticipated effects of such actions, so that the managements and shareholders of both bidders and targets are in a position to make an informed decision about whether to proceed with the transaction (see Testimony, pages 11–13).

Question 9. How would you define a "junk bond"? Are there other debt or equity instruments with similar characteristics to those of junk bonds that we should be concerned about in evaluating the deductibility of interest?

Answer. Since Control Data's overriding concern is in the area of hostile takeovers, we would leave to another day debating the question of what constitutes a "junk bond." In our view, interest deductions should be denied in connection with any debt incurred for purposes of a hostile takeover—even if "investment grade" or totally secured debt.

Question 10. Does the election under Section 338 of the Internal Revenue Code to step up the basis of assets cause mergers to happen or does it instead influence the form of the merger?

Answer. Both (see Testimony, pages 18–19).

Question 11. What impact would a repeal of the Section 338 election have on mergers? Would it decrease the number of mergers and/or affect the terms of some mergers such as pricing?

Answer. Control Data's suggestion is not that Section 338 be repealed as to all "mergers," but that only a hostile purchaser be precluded from stepping up the basis of a target corporation's assets for purposes of depreciation and amortization unless the step-up is recaptured and taxed (see above answer to Question 4 concerning the fundamental distinction where the parties to a negotiated transaction mutually take into account tax consequences along with all other relevant considerations).

Question 12. Some tax experts argue that certain mergers are driven by profitable corporations seeking to offset their income by acquiring firms with net operating losses.

(a) In your experience, has the existence of NOL carryovers been involved in any mergers activity involving your company?

(b) Should consideration be given to limiting or increasing the transferability of NOLs in mergers?

Answer. To my knowledge, the existence of NOL carryovers has not been a significant factor in any Control Data merger. Again, we would favor limiting transferability of NOLs in hostile takeovers.

Question 13. There have been recent reports that managements of some target corporations are using Employee Stock Option Plans (ESOP) as a defensive takeover tactic.

(a) Is the use of an ESOP as a defensive takeover tactic consistent with the Congressional intent for such plans?

(b) What problems of employees in such situations should be of concern to us?

(c) Have ESOPs been used or discussed in any of the mergers with which you are familiar? If so, what were the circumstances and what were the results?

Answer. Control Data does not have an ESOP. A greater concern, in our view, is the potential "raiding" of overfunded pension plans by bidders. As for ESOPs, so long as the beneficial owners of any shares are in a position to act in an informed manner (which Congress could remedy by mandating increased disclosure in connection with any takeover), any potential for abuse should disappear. Finally Congressional intent—while often difficult to discern—was to encourage employee ownership of the companies for which they work, thereby giving them a greater "stake" in ensuring both their employer's success and their own futures. Hostile takeovers by definition take away that ownership and are thus inherently inconsistent with Congress' intent. At least defensive tactics attempt to maintain such ownership.

Question 14. Has your company made greenmail payments or been asked to make such payments?

Answer No.

Question 15. Should greenmail payments be prohibited or penalized? If so, should such regulation be done through the securities laws and/or the tax laws?

Answer. See Testimony, pages 15–17.

Question 16. Should a corporation making greenmail payments be allowed to deduct those payments in whole or in part as ordinary and necessary business expenses? Has your company taken or proposed to take such deductions?

Answer. Control Data has never paid greenmail.

Question 17. Do you feel that high-tech companies are attractive targets for potential acquiring companies? If so, why?

Answer. It is impossible to generalize. Recent history suggests that any company is vulnerable, irrespective of size or industry. Current economic conditions and their

impact on semiconductor and computer firms would suggest that they may be entering a period of vulnerability.

Question 18. Do you feel that all acquisitions are bad? If not, do you feel that all "hostile" acquisitions are bad? If so, why? If not, what is it about the recent merger activity which is of concern to you?

Answer. All acquisitions are not bad and, in many situations, can be highly beneficial to the economy and all relevant constituencies. As a general proposition, however, we believer that "hostile" takeovers are inherently undesirable—as much for the business "atomosphere" that they encourage as for the impact of any particular transaction (see Testimony pages 2–9). If the takeover process were made more "fair," this generalization would evaporate since only net-beneficial takeovers would be attempted and/or consummated.

Question 19. What you consider to be an acceptable debt/equity ratio for your company? Is this typical for the high-tech industry? At what debt/equity level would you consider your company to be in jeopardy? Hypothetically, do you feel that increasing your company's debt/equity ratio in the course of fighting a takeover attempt is justified? If so, why?

Answer. Control Data's debt/equity ratio is somewhat atypical of our industry since a significant portion of the company (Commercial Credit) is engaged in offering financing and financial services. Whether an increase in the debt/equity ratio would be justified in the course of fighting a takeover would depend on the nature of the threat and the good faith business judgment of the directors in responding to that threat. Unfortunately, the present laws do not adequately require disclosure sufficient to facilitate ready analysis as to the nature of a takeover threat, and thus indirectly may encourage over-reaction by targets.

Chairman PICKLE. We appreciate your patience and indulgence and are glad to have testimony from one of the outstanding corporations in America.

Before we adjourn, the Chair wants to announce that the subcommittee will resume tomorrow at 12 noon, in room 1100, the regular Ways and Means Committee room.

We are going to hear from four different panels tomorrow starting at noon and allowing approximately an hour and a half for each panel. We hope on the first panel to have T. Boone Pickens, president of the Mesa Corp.; and G. Chris Andersen, representing Drexel Burnham Lambert.

Panel 2 will be Union Oil of California, represented by Fred L. Hartley, chairman and president; and Phillips Petroleum Co., represented by William C. Douce, chairman of the board and chief executive officer.

The third panel will be Eric Gleacher, Morgan Stanley & Co., Inc.; Louis Perlmutter, Lazard Freres; and Robert A. Profusek, Jones, Day, Reavis & Pogue.

The fourth panel will be Prof. Martin Ginsburg; William McKee of King & Spalding; and Eugene J. Keilin, Lazard Freres.

That meeting will start at 12 noon, in room 1100, of the Ways and Means Committee.

Thank you all for being with us today. The committee stands adjourned.

[Whereupon, at 4:05 p.m., the subcommittees adjourned.]

TAX ASPECTS OF ACQUISITIONS AND MERGERS

TUESDAY, APRIL 2, 1985

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT AND
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The subcommittees met, pursuant to notice, at 1:45 p.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the Subcommittee on Oversight) and Hon. Charles B. Rangel (chairman of the Subcommittee on Select Revenue Measures) presiding.

Chairman PICKLE. The Chair will ask the Oversight Subcommittee to come to order and ask that we proceed as quickly as possible.

I first want to express my deep regrets that we have been delayed in the beginning of the hearing. We are very mindful of the fact that we are at least 2 hours late, and 4, depending on earlier calculations, but we could not help it. We will try to proceed today as quickly as we can and make as much time as possible.

Originally, we had hoped to say to each panel that we could have approximately 1½ hours of questioning. In view of the fact that it is 2 o'clock now and we have possibilities of two or three votes on the floor, we are going to try to cut that down a little bit and I would ask the Members to cooperate by trying to choose your questions. We'll not cut anybody off, but we need to move as quickly as we can in the overall hearing.

The first—and the Chair will ask our guests to please take a seat so we will maintain order here—our first panel today will consist of Mr. T. Boone Pickens and Mr. G. Chris Andersen. I'm going to ask Mr. Pickens and Mr. Andersen if they'll come forward and take a seat here at the witness table directly in front of us.

Mr. Pickens and Mr. Andersen, and if you would care to bring anyone with you to the table as your counsel or accompanyist, you may do so.

Mr. Boone Pickens, the gentleman pouring the water on my right, is chairman and president of the Mesa Petroleum Co. and one of the better-known or well-known men in the country today. The other gentleman, Mr. G. Chris Andersen, is managing director of Drexel Burnham & Lambert.

Chairman RANGEL. Mr. Chairman?

Chairman PICKLE. Yes, Mr. Rangel? Congressman Rangel?

Chairman RANGEL. I'd like to join with you since the Oversight Subcommittee has requested that the Select Revenue Subcommittee, the subcommittee which I chair, join with you in this very important

matter. I would also like to thank our witnesses and apologize, as you have, for the delay. I would like to point out that it has not been the objective of this committee to determine whether or not mergers and acquisitions should take place, but rather to make certain that they are taking place for economic reasons rather than primarily for tax reasons.

To that extent, my subcommittee is looking into net operating losses, trying to determine to what degree, if any, they are a consideration in terms of mergers and acquisitions. We do hope the witnesses would bear that in mind while giving their testimony.

I thank the chairman for allowing me this opportunity.

Chairman PICKLE. Thank you, Mr. Rangel.

Mr. Schulze, would you care to make any opening statement?

Mr. SCHULZE. Thank you, Mr. Chairman. Only to welcome our witnesses and to say that yesterday was very productive and we look forward to gathering more information upon which we can make our judgments.

Chairman PICKLE. The Chair would also want to state at beginning that this is the second day of our subcommittee hearings. There will be another hearing on April 16, and perhaps others, if it seems necessary.

There is considerable division of thought about this question, but I think it is clear that the tax laws are not neutral in this particular subject. We know that corporations can deduct interest payments on debt used to finance acquisitions. We know that corporations can structure their deals so that asset basis is stepped up for depreciation purposes with no tax paid on the gain. We know that deals can be structured as an installment sale with interest costs deducted currently, and the tax deferred way into the future.

We're not trying to pass judgment whether these mergers are either good or bad, and that's true for the acquisitions or the takeovers. We're trying to find out, how is the Tax Code—if it is being used—used as an incentive toward these mergers and these acquisitions? That's the emphasis that will be placed on the hearing today and as we go along.

I now want to recognize Mr. Boone Pickens from Amarillo, TX, my State, who is a very successful man and has been very active in this field. We are pleased to have you here, Mr. Pickens. We are pleased that you would accept our invitation and come and be with us, and we recognize you now for your statement.

Could I ask you, and I ask the other gentleman, to try to limit your statement in the neighborhood of 5 minutes or thereabouts—perhaps 10—so that we might reserve some time then for the Members.

Mr. Pickens.

STATEMENT OF T. BOONE PICKENS, JR., CHAIRMAN AND PRESIDENT, MESA PETROLEUM CO.

Mr. PICKENS. Mr. Chairman, I'm Boone Pickens, chairman of Mesa Petroleum, and I appreciate the opportunity to appear before you today. And I request that the full text of my remarks be submitted for the record.

Chairman PICKLE. Without objection.

Mr. PICKENS. While I'm not a tax expert, I do understand the energy business in which recent takeover activity has occurred.

I urge you to proceed cautiously on pending legislation to be certain it does not erode shareholders' rights. Shareholders are the cornerstone of the free enterprise system, and managements must not be insulated from the responsibility to those shareholders.

Recognizing its need to perform for shareholders, Mesa has grown through successful exploration and acquisition; 5 years after our incorporation, with assets less than $2 million, Mesa acquired a company 20 times its size; that was in 1969; 3 years later, in 1973—and believe it or not, we acted as a white knight to acquire another company. Today, Mesa ranks as the second largest independent oil and gas company in the United States on an equivalent Btu basis. We reached production highs in February 1985 just this year with 365 million cubic feet of gas a day produced and 12,000 barrels of liquid. And we have a capacity to produce at a rate of about 550 million cubic feet a day.

The energy industry is in transition, primarily because there is a scarcity of good drilling prospects, high finding costs, and unstable and uncertain energy prices. Some managements have failed to adapt to the transition; in fact, they even ignore it. We've had a declining reserve base in the United States since 1972. Mergers are a natural response to the changing economics of the energy industry, and they are not primarily tax motivated. The primary reason mergers are good is that they give shareholders a mechanism for holding managements accountable.

There have been ridiculous abuses by managements. For instance, one CEO has his—and I underline his—his $25 million jet equipped with a piano. Can you imagine that, Mr. Chairman? Now, he'll tell you, if he speaks up on the issue today, that the piano was purchased by the employees of the company. Well, the piano cost $500, but it cost about $50,000 to install it in the airplane.

Another CEO has a hunting lease in south Texas that costs over $300,000 a year to maintain. Who pays for all this? I can tell you.

Mr. Chairman, there is more involved here than simple tax considerations—the public interest, shareholder interests, market interests, and energy policy interests are also involved, to name a few. Before I begin my discussion on those points, I would like to outline Mesa's accomplishments.

Mesa is a prime example of a small company that has grown through successful exploration and acquisition; 5 years after incorporation in 1969, with total assets of less than $2 million, Mesa tendered for and acquired another public corporation engaged in the production of hydrocarbons. This company was 20 times the size of Mesa. It was quickly assimilated into Mesa and the combined financial and human resources fueled the company's rapid growth.

Several years later, in 1973, Mesa acquired another company as a white knight, and the procedure was repeated. In each instance, efficiencies of operation were greatly improved and return on shareholders' investments was enhanced.

We proved that through acquisitions, a larger and more profitable company could emerge. The expanded exploration budgets made possible by the business combinations made us a stronger company with greater long-term viability. These acquisitions provided both short- and long-term value to our shareholders.

Each year since its inception, Mesa has replaced and enhanced its reserve base. Replacement has been achieved primarily through intensive exploration and development. We have invested over $1.8 billion in offshore exploration and development in the Outer Continental Shelf and have an average interest of 30 percent in 50 offshore platforms. During the last 5 years, total additions to Mesa's liquid reserves before acquisitions represented 139 percent of production and additions to natural gas reserves represented 187 percent of production. Our total assets today are approximately $4 billion, and our net income last year was $254 million on revenues of $413 million.

In 1981, our capital budget was $420 million; this sum was twice our cash flow. In 1982, the budget was $320 million, still in excess of cash flow. In 1983, it was $223 million, and the 1984 budget was $110 million, excluding the $500 million purchase of proved reserves—the Mesa royalty trust. The 1985 budget is $90 million. This current budget represents about 40 percent of our cash flow, which percentage is consistent with practice in the industry. Our decision to bring capital expenditures in line with cash flows was a calculated decision based upon our concern over the near-term future of the oil and gas business. It had no relation to our having created royalty trusts or our having invested in other energy companies.

The most recent data covering the Fortune 500 companies shows that Mesa would be included in the top five energy companies in assets and net income per employee, and in net income as a percent of stockholders' equity. An investor who purchased 1,000 shares of Mesa for $10,000 when the company was founded in 1964, as a result of the stock splits and the creation of two royalty trusts, would now have an investment with a market value of approximately $312,000.

Mesa's management understands that shareholders are the cornerstone of corporate America because they are the people who risk their money to invest in business. Mesa stock is valued by John S. Herold at $19 per share and on March 29, 1985, its closing price was 19⅞, over 100 percent of its appraised value. Our market price as compared to appraised value is strong because of our entrepreneurial management.

Now let's turn to the specific points I want to make about the restructuring of the energy industry and the effect legislative changes might have on that process.

First, mergers among energy companies are motivated by the market realities of an industry in transition. Recent acquisitions are driven primarily by the need of companies to replace diminishing reserves in the most economic fashion. The industry today is in the midst of an internal restructuring, which represents a response to existing market forces. Recent cutbacks in drilling simply reflect the realities of exploration economics: a scarcity of good drilling prospects, high finding costs, and stable energy prices. There is a serious question whether or not current energy prices afford sufficient economic incentive to explore in frontier areas.

Second, mergers are recognized by authorities in Government and industry not to be primarily tax motivated. In testimony before a Senate Finance Subcommittee last year on oil company

mergers, and again yesterday before this committee, Ronald Pearlman, Assistant Secretary of the Treasury for Tax Policy, stated that the current tax rules are not propelling the recent flurry of oil company acquisitions, and that Congress should not amend the tax laws for the purpose of discouraging these mergers. George Keller, chairman and chief executive Officer of Standard Oil Co. of California, also stated emphatically before the Senate Finance Committee last year that the SoCal-Gulf merger was not made for tax purposes and that the idea of gaining tax benefits from the merger played absolutely no part in the company's thinking.

Finally, I stated in questions posed by the Senate Judiciary Committee last year that tax considerations were not major factors in Mesa's bid for Gulf.

Third, a basic underlying cause of corporate mergers today is management inefficiency. As this year's Economic Report of the President so fundamentally pointed out, the American economy's success depends on competition. Competition should also play a significant role in what is a healthy market for corporate control. An active merger market is a healthy threat to incompetent management. It is good for the economy because it shifts corporate assets from poor managers to more efficient ones, as often stated by Assistant Attorney General for Antitrust, J. Paul McGrath. Further support for this view has come from the respected economist Michael Jensen, as quoted in USA Today, March 20, 1984:

> The merger market is really part of the labor market for top corporate managers. There's no unemployment bureau for CEO's of billion dollar firms * * * [managers and directors] are appealing for help outside the market—legislative help to protect them from the market.

I think these views lend support to the widely held view that corporate mergers are not motivated or driven by the tax laws. Other, and in many ways more substantial, forces are at work.

Fourth, proposed tax legislation will adversely affect shareholders. The key point to bear in mind in this debate is that companies involved in mergers are not owned by managements, but by shareholders. It is their interest which should be paramount. There are 42 million shareholders who own stock in publicly traded companies. This represents one out of six Americans, or 190,000 in each congressional district in the United States. Stockholders place their investments in the hands of management and expect management will do its best to keep the market value of their investments as close as possible to its true value.

If investors are dissatisfied with management performance, they will serve notice on management to improve the return on assets left under their control. Too often unresponsive managements give the small investor little choice but to sell. Restrictions on legitimate tender offers would deprive these investors of that basic property right, the right to sell.

Mesa would not invest if we did not believe that management would respond in a positive way to our ownership. The small investor can have a tough time getting management's attention.

Both the Getty family, large owners of Getty Oil, and the Keck family, large owners of Superior, had the financial clout, as we do, to confront managements and make them respond. In each case, both large and small shareholders benefited.

The great weight of evidence expressed in congressional testimony last year on antimerger legislation in the House and Senate, as well as again this year before the House Energy and Commerce Committees, is that mergers have been beneficial to shareholders and the economy.

A number of studies have pointed out that target company shareholders who tender their shares benefit from a premium over the market price which averages in a range of 30 to 35 percent. For the bidder, the average gain is 3 to 4 percent. Legislative restrictions on mergers would deny to shareholders this premium and thus, in effect, would impose a new restraint on shareholder value.

Fifth, proposed tax legislation will adversely affect capital markets and the economy. The effect of tax legislation which impedes corporate acquisitions could be severe. Corporate acquisitions are an important goal of entrepreneurial activity in our economy. Private entrepreneurs, financed by venture capitalists, are the primary creators of new jobs and new businesses.

Sir James Goldsmith addresses this in an article in the March 1985 edition of Financier magazine. He notes that since 1965, 35 million new jobs have been created in the United States. In that same period the largest companies among the Fortune 500 lost 3 million jobs. A minimum of 85 percent of all corporations have subordinated debt which would be rated less than investment grade. Yet, a minimum of 80 percent of all jobs created since 1965 were created by corporations with debt rated less than investment grade.

Mergers create wealth. They are a natural product of the economy's need to allocate capital efficiently. They operate to free investment capital from inefficient usage and permit it to flow to the innovative and efficient, thereby enhancing the creation of wealth. To establish prohibitive tax barriers to this type of activity would be to harden the arteries that carry the lifeblood of our economic system—investment capital.

Arbitrary tax rules could also weaken our securities markets. They could adversely affect the willingness of investors to put their savings into corporate equities and thus impair the ability of corporations to raise capital. If the shareholder's right to sell is restricted, equity securities would no longer be as attractive for investment purposes. This would aggravate the existing bias in the tax law in favor of debt as compared to equity financing—ironically, the very condition that some proponents advance in support of antimerger tax legislation. Once investor confidence is weakened, equity markets will deteriorate to the detriment of capital formation.

If legislation restricting mergers and tender offers is ever enacted into law the Securities and Exchange Commission should, in the interest of fairness and full disclosure, require that all stock certificates contain an appropriate boldface legend: "Warning: It's the law—your ability to realize the highest price for these shares is severely restricted."

Sixth, proposed tax legislation designed to thwart mergers in the petroleum industry might adversely affect energy exploration and drilling by inhibiting the most efficient combination of resources and expertise. As stated in The New York Times on March 21, 1984:

The multibillion dollar mergers reshaping the American oil industry may also offer new economies of scale that make exploration efforts more fruitful * * * Thus, when these separate resources are thrown together in a merger, the reasoning goes, the company that emerges can select its drilling projects from a richer list using the combined and presumably enhanced expertise that also results.

Congress should not approve antimerger tax legislation on the misbegotten notion that it would cause the energy industry management to drill more domestic wells. There is plenty of money in the industry today to drill all the economically feasible prospects that are available. Rigs aren't drilling because the economics are bad. The number of rigs working in the United States today is less than half the number that were working in December 1981. The high watermark at that time was 4,531 rigs operating; today we have only 1,939 rigs running. Tampering with the tax laws would only reduce the rig count further.

Seventh, proposed tax legislation would adversely affect Treasury revenues. The subcommittee should note that mergers increase Federal revenues substantially, and that adoption of antimerger tax proposals could result in the loss of these revenues. For example, premiums paid in merger transactions have been a major generator of capital gains tax revenues, and any specific tax restraint on mergers would result in a decline in portfolio values for shareholders, resulting in smaller gains or perhaps capital losses. Testimony in the Senate last year on the tax aspects of oil company mergers suggested that tax revenues from the SoCal-Gulf merger alone were estimated to be $2 billion. In the three takeover attempts in which Mesa Petroleum Co. has been involved recently, 750,000 shareholders have made a pretax profit of roughly $13 billion, and Federal coffers have been enriched by approximately $3 billion in taxes.

Eighth, pending tax bills aimed to deter mergers are inherently flawed. The most simplistic proposal would deny the deductibility of interest on debt incurred to acquire another company, on the premise that current law represents a tax subsidy in favor of mergers. This is simply an incorrect characterization of the facts.

Our tax laws have always permitted corporations to deduct interest for funds borrowed, whether to purchase stock, or real assets, to build a plant, or equipment, to develop new products, or for general operating purposes. There is no reason to view the acquisition of a company through a merger as any different than we would view the acquisition of these other properties. I see little basis to discriminate against mergers in general as opposed to other types of capital transactions.

The subcommittee should note also that the borrowing of funds does not create interest deductions for the borrower without creating corresponding interest income for the lenders, which is subject to tax.

Denying the interest deduction would also prevent the most efficient allocation of capital in our economy. This requires mechanisms to match willing buyers and sellers and the freedom of sellers to sell to the highest bidder. Income tax rules should not attempt to dictate credit allocation in this free market, because it would remove the highest bidders in the targeted industry from the

market. This would be bad tax policy and would create a dangerous legislative precedent.

Other tax bills would determine tax consequences of a proposed acquisition on the approval or disapproval of the target company's board of directors. This represents questionable tax policy because it is contrary to the determinations of the free marketplace. It would shift the balance between the bidder and target in favor of the management of the targets, although not necessarily in favor of the shareholders. And it could create a situation in which directors would be offered payoffs in return for approving a deal.

Let me add a word about provisions in certain tax bills that are designed to curb greenmail. Greenmail is properly defined as the repurchase of a corporation's stock by the corporation from a large, relatively new shareholder where the same offer to repurchase is not made to all shareholders. I have always been an outspoken opponent of greenmail because by its very definition it discriminates among shareholders, and thus is antishareholder. While legislation designed to curb this practice may be well intentioned, these antimerger tax bills miss the mark. I question whether use of the Tax Code is the best method to adopt to correct what is essentially a securities law matter. But the larger point is that greenmail is a trademark of weak management. The way to end it is not to penalize the shareholder who receives it, as these bills would do, but the managements who pay it.

In conclusion, Mr. Chairman, I would like to reiterate three major points.

Mergers are not motivated by the tax laws or by some kind of quick-profit scheme. They reflect the response of sensible shareholders alert to market changes and problems with management. Mergers are a means by which shareholders exercise the right to run the corporations they rightfully own.

Proposed tax law changes would be pointlessly punitive. Arbitrary legislation of this type can only send a chilling message to the private sector—that Government has lost its sense of cause and effect in the economy and has determined that it can better provide for the economic health of the Nation than can the private sector.

The best defense against a takeover is for management to utilize corporate assets efficiently to keep the company's stock priced high. That is the best defense for any management. When they become vulnerable, it's when they're selling at a deep discount to the appraised value.

Thank you.

[The prepared statement follows:]

STATEMENT OF T. BOONE PICKENS, JR., PRESIDENT AND CHAIRMAN OF THE BOARD, MESA PETROLEUM CO.

Mr. Chairman, it is a pleasure for me to appear before you and to address the important issues relating to the tax aspects of mergers and acquisitions described in the March 8 and 22, 1985, press releases of the Ways and Means Committee announcing today's hearing. I appreciate the opportunity to share my views on the economic and practical implications of proposed tax legislation designed largely for the purpose of discouraging corporate mergers and acquisitions.

While I am not a tax expert, I do understand the energy industry, in which a portion of recent takeover activity has taken place. Accordingly, I know what has,

and what has not, been the primary motivation behind the recent surge in merger activity in that industry.

For the reasons detailed below, I would urge the Subcommittee to move cautiously in considering the pending legislative proposals. It should reject misguided proposals that, in my view, reflect a basic misunderstanding of the realities of the marketplace, in general, and what is now occurring in the energy industry, in particular.

These bills implicitly assume, against the great weight of evidence, that mergers are somehow bad per se and that it is appropriate to add provisions to the tax code specifically to discourage hostile takeovers. They overlook the overwhelming benefits of mergers that accrue to the economy and to its key participant, the American shareholder. These bills serve only to protect incumbent management, often to the detriment of shareholders. They are simplistically drawn and do not address at all the true cause of corporate mergers. The primary reason mergers are good is that they provide shareholders a means for calling corporate management into account. How else can you question such ridiculous abuses as the CEO who exclusively uses "his" $25 million jet and has equipped it with a piano?

Mr. Chairman, there is more involved here than simple tax considerations—the public interest, shareholder interests, market interests, and energy policy interests are also involved, to name a few. Before I begin my discussion on those points, I would like to outline Mesa's accomplishments.

Mesa is a prime example of a small company that has grown through successful exploration and acquisition. Five years after incorporation in 1969 (with total assets of less than $2 million), Mesa tendered for and acquired another public corporation engaged in the production of hydrocarbons. This company was 20 times the size of Mesa. It was quickly assimilated into Mesa and the combined financial and human resources fueled the company's rapid growth.

Several years later in 1973, Mesa acquired another company as a white knight, and the procedure was repeated. In each instance, efficiencies of operation were greatly improved and return on shareholders' investments was enhanced.

We proved that through acquisitions, a larger and more profitable company could emerge. The expanded exploration budgets made possible by the business combinations made us a stronger company with greater long-term viability. These acquisitions provided both short- and long-term value to our shareholders.

Each year since its inception, Mesa has replaced and enhanced its reserve base. Replacement has been achieved primarily through intensive exploration and development. We have invested over $1.8 billion in offshore exploration and development in the Outer Continental Shelf and have an average interest of 30 percent in 50 offshore platforms. During the last five years, total additions to Mesa's liquid reserves before acquisitions represented 139 percent of production and additions to natural gas reserves represented 187 percent of production. Our total assets today are approximately $4 billion and our net income last year was $254 million on revenues of $413 million.

In 1981, our capital budget was $420 million; this sum was twice our cash flow. In 1982, the budget was $320 million—still in excess of cash flow, in 1983 it was $223 million, and the 1984 budget was $110 million, excluding the $500 million purchase of proved reserves (Mesa Royalty Trust). The 1985 budget is $90 million. This current budget represents about 40% of our cash flow, which percentage is consistent with practice in the industry. Our decision to bring capital expenditures in line with cash flows was a calculated decision based upon our concern over the near-term future of the oil and gas business. It had no relation to our having created royalty trusts or our having invested in other energy companies.

The most recent data covering the Fortune 500 companies shows that Mesa would be included in the top five energy companies in assets an net income per employee, and in net income as a percent of stockholders' equity. An investor who purchased 1,000 shares of Mesa for $10,000 when the company was founded in 1964, as a result of the stock splits and the creation of two royalty trusts, would now have an investment with a market value of approximately $312,000.

In addition, Mesa ranks as the second largest independent oil and gas company in the U.S. on an equivalent BTU basis. The company reached its all-time production high in January of this year and topped it in February, producing 365 MMCFPD of gas and 11,967 of oil and liquids. Mesa has the capacity to produce 500 MMCFPD of gas.

Mesa's management understands that shareholders are the cornerstone of corporate American because they are the people who risk their money to invest in business. Mesa stock is valued by John S. Herold at $19 per share and on March 29, 1985, its closing price was 19⅞, over 100% of its appraised value. Our market price

as compared to appraised value is strong because of our entrepreneurial management.

Now let's turn to the specific points I want to make about the restructuring of the energy industry and the effect legislative changes might have on that process.

First, mergers among energy companies are motivated by the market realities of an industry in transition. Recent acquisitions are driven primarily by the need of companies to replace diminishing reserves in the most economic fashion. The industry today is in the midst of an internal restructuring, which represents a response to existing market forces. Recent cutbacks in drilling simply reflect the realities of exploration economics: a scarcity of good drilling prospects, high finding costs, and stable energy prices. There is a serious question whether or not current energy prices afford sufficient economic incentive to explore in frontier areas.

Second, mergers are recognized by authorities in government and industry not to be primarily tax-motivated. In testimony before a Senate Finance Subcommittee last year on oil company mergers, and again yesterday before this Committee, Ronald Pearlman, Assistant Secretary of the Treasury for Tax Policy, stated that the current tax rules are not propelling the recent flurry of oil company acquisitions, and that Congress should not amend the tax laws for the purpose of discouraging these mergers. George Keller, Chairman and Chief Executive Officer of Standard Oil Co. of California, also stated emphatically before the Senate Finance Committee last year that the SoCal-Gulf merger was not made for tax purposes and that the idea of gaining tax benefits from the merger played absolutely no part in the company's thinking. Finally, I stated in questions posed by the Senate Judiciary Committee last year that tax considerations were not major factors in Mesa's bid for Gulf.

Third, a basic underlying cause of corporate mergers today in management inefficiency. As this year's "Economic Report of the President" so fundamentally pointed out, the American economy's success depends on competition. Competition should also play a significant role in what is a healthy market for corporate control. An active merger market is a healthy threat to incompetent management. It is good for the economy because it shifts corporate assets from poor managers to more efficient ones, as often stated by Assistant Attorney General for Antitrust, J. Paul McGrath. Further support for this view has come from the respected economist Michael Jensen, as quoted in USA Today, March 20, 1984:

"The merger market is really part of the labor market for top corporate managers. There's no unemployment bureau for CO's of billion dollar firms . . . [managers and directors] are appealing for help outside the market—legislative help to protect them from the market."

I think these views lend support to the widely held view that corporate mergers are not motivated or driven by the tax laws. Other, and in many ways, more substantial forces are at work.

Fourth, proposed tax legislation will adversely affect shareholders. The key point to bear in mind in this debate is that companies involved in mergers are not owned by managements, but by shareholders. It is their interest which should be paramount. There are 42 million shareholders who own stock in publicly traded companies. This represents one out of six Americans, or 100,000 in each congressional district in the United States. Stockholders place their investments in the hands of management and expect management will do its best to keep the market value of their investments as close as possible to its true value.

If investors are dissatisfied with management performance, they will serve notice on management to improve the return on assets left under their control. Too often unresponsive managements give the small investor little choice but to sell. Restrictions on legitimate tender offers would deprive these investors of that basic property right, the right to sell.

Mesa would not invest if we did not believe that management would respond in a positive way to our ownership. The small investor can have a tough time getting management's attention.

Both the Getty family, large owners of Getty Oil, and the Keck family, large owners of Superior, had the financial clout, as we do, to confront managements and make them respond. In each case both large and small shareholders benefitted.

The great weight of evidence expressed in Congressional testimony last year on anti-merger legislation in the House and Senate, as well as againt this year before the House Energy and Commerce Committee, is that mergers have been beneficial to shareholders and the economy.

A number of studies have pointed out that target company shareholders who tender their shares benefit from a premium over the market price which averages in a range of 30–35 percent. For the bidder, the average gain is 3–4 percent. Legisla-

tive restrictions on mergers would deny to shareholders this premium and thus in effect would impose a new restraint on shareholder value.

Fifth, proposed tax legislation will adversely affect capital markets and the economy. The effect of tax legislation which impedes corporate acquisitions could be severe. Corporate acquisitions are an important goal of entrepreneurial activity in our economy. Private entrepreneurs, financed by venture capitalists, are the primary creators of new jobs and new businesses.

Sir James Goldsmith addresses this in an article in the March 1985 edition of Financier Magazine. He notes that since 1965, 35 million new jobs have been created in the U.S. In that same period the largest companies among the Fortune 500 lost three million jobs. A minimum of 85% of all corporations have subordinated debt which would be rated less than investment grade. Yet a minimum of 80% of all jobs created since 1965 were created by corporations with debt rated less than investment grade.

Mergers create wealth. They are a natural product of the economy's need to allocate capital efficiently. They operate to free investment capital from inefficient usage and permit it to flow to the innovative and efficient, thereby enhancing the creation of wealth. To establish prohibitive tax barriers to this type of activity would be to harden the arteries that carry the life blood of our economic system—investment capital.

Arbitrary tax rules could also weaken our securities markets. They could adversely affect the willingness of investors to put their savings into corporate equities and thus impair the ability of corporations to raise capital. If the shareholder's right to sell is restricted, equity securities would no longer be as attractive for investment purposes. This would aggravate the existing bias in the tax law in favor of debt as compared to equity financing—ironically, the very condition that some proponents advance in support of anti-merger tax legislation. Once investor confidence is weakened, equity markets will deteriorate to the detriment of capital formation.

If legislation restricting mergers and tender offers is ever enacted into law the Securities and Exchange Commission should, in the interest of fairness and full disclosure, require that all stock certificates contain an appropriate boldface legend: "Warning: It's the Law—Your Ability to Realize the Highest Price for These Shares is Severely Restricted."

Sixth, proposed tax legislation designed to thwart mergers in the petroleum industry might adversely affect energy exploration and drilling by inhibiting the most efficient combination of resources and expertise. As stated in The New York Times on March 21, 1984:

"The multibillion-dollar mergers reshaping the American oil industry may also offer new economies of scale that make exploration efforts more fruitful. . . . Thus, when these separate resources are thrown together in a merger, the reasoning goes, the company that emerges can select its drilling projects from a richer list using the combined and presumably enhanced expertise that also results."

Congress should not approve anti-merger tax legislation on the misbegotten notion that it would cause the energy industry management to drill more domestic wells. There is plenty of the money in the industry today to drill all the economically feasible prospects that are available. Rigs aren't drilling because the economics are bad. The number of rigs working in the U.S. today is less than half the number that were working in December 1981. The high water mark at that time was 4,531 rigs operating; today we have only 1,939 rigs running. Tampering with the tax laws would only reduce the rig count further.

Seventh, proposed tax legislation would adversely affect Treasury revenues. The Subcommittee should note that mergers increase federal revenues substantially, and that adoption of anti-merger tax proposals could result in the loss of these revenues. For example, premiums paid in merger transactions have been a major generator of capital gains tax revenues, and any specific tax restraint on mergers would result in a decline in portfolio values for shareholders, resulting in smaller gains or perhaps capital losses. Testimony in the Senate last year on the tax aspects of oil company mergers suggested that tax revenues from the SoCal-Gulf merger alone were estimated to be $2 billion. In the three takeover attempts in which Mesa Petroleum Co. has been involved in recently, 750,000 shareholders have made a pre-tax profit of roughly $13 billion, and Federal coffers have been enriched by approximately $3 billion in taxes.

Eighth, pending tax bills aimed to deter mergers are inherently flawed. The most simplistic proposal would deny the deductibility of interest on debt incurred to acquire another company, on the premise that current law represents a "tax subsidy" in favor of mergers. This is simply an incorrect characterization of the facts.

Our tax laws have always permitted corporations to deduct interest for funds borrowed, whether to purchase stock or real assets, to build a plant or equipment, to develop new products or for general operating purposes. There is no reason to view the acquisition of a company through a merger as any different than we would view the acquisition of these other properties. I see little basis to discriminate against mergers in general as opposed to other types of capital transactions.

The Subcommittee should note also that the borrowing of funds does not create interest deductions for the borrower without creating corresponding interest income for the lenders, which is subject to tax.

Denying the interest deduction would also prevent the most efficient allocation of capital in our economy. This requires mechanisms to match willing buyers and sellers and the freedom of sellers to sell to the highest bidder. Income tax rules should not attempt to dictate credit allocation in this free market, because it would remove the highest bidders in the targeted industry from the market. This would be bad tax policy and would create a dangerous legislative precedent.

Other tax bills would determine tax consequences of a proposed acquisition on the approval or disapproval of the target company's board of directors. This represents questionable tax policy because it is contrary to the determinations of the free marketplace. It would shift the balance between the bidder and target in favor of the management of the targets, although not necessarily in favor of the shareholders. And it could create a situation in which directors would be offered payoffs in return for approving a deal.

Let me add a word about provisions in certain tax bills that are designed to curb "greenmail." "Greenmail" is properly defined as the repurchase of a corporation's stock by the corporation from a large, relatively new shareholder where the same offer to repurchase is not made to all shareholders. I have always been an outspoken opponent of greenmail because by its very definition it discriminates among shareholders, and is thus anti-shareholder. While legislation designed to curb this practice may be well-intentioned, these anti-merger tax bills miss the mark. I question whether use of the tax code is the best method to adopt to correct what is essentially a securities law matter. But the larger point is that greenmail is a trademark of weak management. The way to end it is not to penalize the shareholder who receives it, as these bill would do, but the managements who pay it.

In conclusion, Mr. Chairman, I would like to reiterate three major points:

Mergers are not motivated by the tax laws or by some kind of quick-profit scheme. They reflect the response of sensible shareholders alert to market changes and problems with management. Mergers are a means by which shareholders exercise the right to run the corporations they rightfully own.

Proposed tax law changes would be pointlessly punitive. Arbitrary legislation of this type can only send a chilling message to the private sector—that government has lost its sense of cause and effect in the economy and has determined that it can better provide for the economic health of the nation than can the private sector.

The greatest defense against a takeover is for management to utilize corporate assets efficiently to maximize the return for its shareholders. It is not by legislative tampering through the tax code, which may appear to have superficial appeal, but which would result in serious harm to shareholders and the economy as a whole.

Chairman PICKLE. Thank you, Mr. Pickens.

I believe that, in the interests of procedure, we'll ask Mr. Andersen to go ahead and make your statement, and then together the committee members can ask questions of either one of you.

STATEMENT OF G. CHRIS ANDERSEN, MANAGING DIRECTOR, DREXEL BURNHAM LAMBERT, INC.

Mr. ANDERSEN. Thank you, Mr. Chairman. I appreciate this opportunity to present the general views of Drexel Burnham Lambert concerning certain economic and tax policy considerations with respect to the current acquisition environment and the high yield bond financing impact on acquisition activity. I will supplement my statement today by delivering for the record additional written testimony that more specifically addresses the tax items.

Again, in the interests of time, I'm just going to read the first part of my statement, and then I will address just one or two questions briefly.

Drexel is one of the leading investment banking firms and has played a major role in development of the high yield bond market. High yield bonds include all issues rated less than triple B. These bonds generally bear interest rates above those of higher rated debt instruments.

Since the market became active about a decade ago, over 350 companies have raised capital in the public markets in this fashion. High yield bonds typically give small companies access to the capital markets. Over 85 percent of all public companies in the United States, if they would apply for ratings today, would be rated below investment grade; yet the companies in this segment include many of the ones that are growing most rapidly, and are therefore most in need of capital. As Mr. Pickens pointed out, these companies are the ones responsible for creating 80 to 90 percent of all the new jobs formed in the United States. It is from this very sector that tomorrow's industrial powerhouses will have to emerge.

High yield bonds basically are a more flexible alternative to traditional forms of financing, such as borrowing from banks, private placements of debt, and stock issuances. The high yield bond market has grown substantially as a result of companies' preferring high yield debt to traditional financing methods as a way of raising capital and the investors' attraction to high yielding instruments. Investors in high yield bonds, which include insurance companies, mutual funds, individuals, pension funds, savings institutions and other institutional investors, receive handsome returns from their high yield bonds relative to the risk of the default rate assumed. High yield bonds have received widespread publicity not only for their importance as a method of raising capital, but also for their role in the financing of acquisition activity. Unfortunately, high yield bonds have become the subject of certain legislative proposals which seek to discourage acquisition activity by denying the deductibility of their interest. In Drexel's view, these proposals are not based on sound economic or tax policy.

I will submit the rest of my statement in writing.

I think the most important thing that I can do is to address the notion of the pejorative term "junk bonds" and what is it.

Prior to the midseventies, most small companies were precluded from the public capital market. In 1974 and 1975 we had no market for new issues and we had no bonds rated less than single A that were financed on the public market. The growing, vital parts of our economy were basically squeezed out of the capital markets.

If you look at the basic premise upon which people oppose these junk bonds, it is the notion that the existing U.S. capital structure has something sacred about it. In their December 1983 issue of the Harvard Business Review, there was an article which noted that the capital structure of the United States has not changed in over a century. Capital structures have changed in all other countries around the world, moving up and down with economic cycles. In this country—we have done a statistical survey of what capitalization should be, and we hold to it. We hold it across all industries.

We've held it just simply because people have not bothered to think, review, and understand the nature of credit ratings.

I submit to you that that is unsound to remain rigid in our views of capital structure. It places us at a competitive disadvantage. If we continue to remain inflexible our major industries will continue to decline because as they go through growth into maturity, they will continue putting their money into industries and into technologies that have decayed, as opposed to creating jobs.

One last, brief comment is on why there exists a market today for acquisitions and takeovers. If you stop to look at a takeover transaction, it is basically an arbitrage transaction that takes place between two different markets, between the public market and other markets which are willing to value these assets higher. And if managements would simply focus on that fact and begin to understand how to more appropriately and aggressively employ their capital resources they would eliminate that differential, and there would be no profit, there would be no basis whatsoever for the activity from which they are seeking protection. It's because they refuse to do the analysis themselves and take the action themselves; and if they don't, someone else, some other stockholder who is an owner of the company, is going to step in and take that opportunity up for them.

I thank you.

[The prepared statement follows:]

STATEMENT OF G. CHRIS ANDERSEN, MANAGING DIRECTOR, DREXEL BURNHAM LAMBERT INC.

Mr. Chairman and members of the subcommittees, I appreciate the opportunity to present generally the views of Drexel Burnham Lambert Incorporated concerning certain economic and tax policy considerations with respect to the current acquisition environment and high yield bond financing of acquisition activity. I will supplement my statement today by submitting for the record, at a later time, written testimony that more specifically addresses recent tax initiatives in this area. Frederick H. Joseph, Senior Executive Vice President and head of Corporate Finance at Drexel, and I have previously testified before the Subcommittee on Telecommunications, Consumer Protection and Finance on similar topics.

Drexel, one of the leading investment banking firms, has played the major role in developing the high yield bond market. High yield bonds include all issues rated Ba1 or lower (Moody's) or BB+ or lower (Standard & Poor's) and generally bear interest at an above-market rate. High yield bonds give small companies access to the capital markets. Over 85 percent of all U.S. public corporations, if they were to apply for a rating, would be rated below investment grade. Yet the companies in this segment include many of the ones that are growing most rapidly and therefore need new capital. This is the segment that has been responsible for 80–90 percent of all job formation in the United States. It is from this sector that many of tomorrow's industrial powerhouses will emerge.

High yield bonds are a more flexible alternative to "traditional" forms of financing, such as borrowing from banks, private placements of debt and stock issuances. The high yield bond market has grown substantially as a result of companies' preferring high yield debt to traditional financing as a method of raising capital and investors' attraction to high yield instruments. Investors in high yield bonds, which include insurance companies, mutual funds, individuals, pension funds, savings institutions and other institutional investors, receive handsome returns from high yield bonds, while the default rate is reasonably low. High yield bonds have received widespread publicity not only for their importance as a method of raising capital but also for their role in the financing of acquisition activity. Unfortunately, high yield bonds have become the subject of certain legislative proposals which seek to discourage acquisition activity by denying the deductibility of interest on debt. In Drexel's view, these proposals are not based on sound economic or tax policy.

Drexel agrees with the many experts who have concluded that merger and acquisition activity results in a number of economic benefits, including the shifting of assets to more productive uses, more efficient forms of distribution and technology transfers that promote new research and development. Acquisitions also expedite the restructuring of unsuccessful conglomerates into more efficient and more valued entities. Acquisition activity serves to spur management to strengthen company performance and may result in the replacement of ineffective management. The chief executive officers of Walt Disney Productions and Martin Marietta Corp. have declared that acquisition attempts on their companies have forced management to become more disciplined.

Furthermore, as many scholarly studies have demonstrated, tender offers result in substantial gains to shareholders of target firms and benefit shareholders of bidding companies. In this regard, acquisitions cause transfers of wealth to shareholders who normally reinvest the proceeds in the capital markets or purchase goods and services, thereby in either case stimulating economic growth and making money available for investment.

Further regulation of acquisitions is unnecessary because the Williams Act strikes an equitable balance between targets and acquirers that allows the market to operate efficiently. There is no evidence that the overall balance between acquirer and target has been upset in recent acquisition activity. Congress should not disrupt the current balance maintained by the securities laws through a modification of the Internal Revenue Code.

As I have indicated, Drexel believes that mergers and acquisitions are valid business strategies which spur economic growth and productivity. They are not driven and are indeed only marginally influenced by tax incentives. Acquisitions are motivated by legitimate business objectives, such as achieving better allocations of resources, substituting new management teams and maximizing other business and economic opportunities. Tax considerations become relevant only in determining the structure of a transaction which is engaged in for nontax reasons, and are not necessarily the controlling consideration with respect to structure.

High yield debt has made an important contribution to acquisition activity by making capital available to finance acquisitions of the largest companies. Previously, sheer size had prohibited economically advantageous acquisitions because of the amount of capital required to finance such transactions. Under recent proposals that would deny the interest deduction with respect to high yield indebtedness, such transactions would be practically limited to large buyers which are able to obtain money through traditional financing methods and which would be entitled to a full interest deduction. Smaller growth companies, which are often a great source of new ideas and more vigorous management, would not be able to afford to offer the same or better prices as large acquirers which can obtain bank financing and deduct interest payments. Thus, such legislation would reduce competition in acquisitions and thereby deny shareholders the opportunity to receive the best premium for their shares.

Drexel also submits that there is no basis for drawing a distinction between the deductibility of interest on funds borrowed from institutions such as banks and funds derived from high yield bonds. Congress has determined that the cost of interest is a valid business expense regardless of the type of capital transaction. Attempting to limit interest deductions only to certain types of indebtedness is impracticable and contrary to the basic objective of tax policy, neutrality. It would also have a discriminatory effect on smaller growing companies.

The federal tax laws have specific provisions designed to determine when a deduction for interest is appropriate. Under these provisions, a determination of the appropriateness of the interest deduction principally involves an inquiry into whether the nominal creditor is a true creditor or more like an equity holder—a participant in the risks and rewards of the corporate enterprise. This analysis involves the application of neutral principles to the terms of financial instruments issued in a broad range of situations. This existing statutory scheme is more than adequate to address any potential abuses of the interest deduction.

With regard to some of the proposed bills which would single out "hostile" acquisitions for unfavorable tax treatment, Drexel believes that the distinction between friendly and unfriendly deals is not logical or appropriate. An acquisition that is consummated has the same characteristics and provides the same benefits to shareholders regardless of whether it is opposed by the target's management. Most "hostile" acquisitions initially opposed by management become friendly transactions following negotiations which increase the price paid to shareholders.

In addition, Drexel believes that proposed tax legislation which conditions tax liability in an unsolicited acquisition on the approval of the target's outside directors

is inappropriate. The Code does not, in any other section, allow the tax treatment of a transaction to turn on such a haphazard factor. Under such a legislative scheme, corporations would soon select outside directors whose views closely coincided with those of management, giving rise to complex definitional determinations as to who is independent—an exercise that would almost certainly result in litigation. Finally, Drexel notes that acquisitions succeed because shareholders favor them, even though target directors may oppose them. There is no reason to give these directors, who may be replaced after the transaction is completed, the power to saddle the new entity with heavy tax liability.

In closing, I would again like to thank the Subcommittees for this opportunity to present our views. I would be happy to answer any questions you may have.

Chairman PICKLE. Mr. Andersen, let me make it plain to you at the outset, and to Mr. Pickens, that we're not holding these hearings for the purposes of trying to protect management. Management hasn't come to us as individuals or as Members in asking for help or relief. We're not considering any bill today. There is no legislation drafted; we're simply looking at these overall questions of mergers and acquisitions and takeovers and how the Tax Code might have a part in that development. So I want to try to make that plain right at the beginning. And I do appreciate you being here, both of you.

I did not mean at the beginning to say that we were going to limit you to, perhaps, 5 or 10 minutes. I want you to have additional time if you want it. We're not trying to cut anybody off. I wish we could have gone through your entire testimony, but I want to assure you we'll be glad to hear anything further.

But first, let me start off by asking Mr. Pickens a few questions. I guess I ought to ask you first, in a friendly manner, how does it feel to be the most feared man in corporate America today?

Mr. PICKENS. Well, Mr. Chairman, when you say "most feared," it may be so by some managements, but certainly not by the stockholders. I get letters every day and I can show you a file cabinet full of them that say, "Dear Mr. Pickens, Have you thought of our company?" And then they attach an annual report of the company they'd like for me to look at.

Chairman PICKLE. All right. And when you go to look it over, one of these companies that you might want to take over, do you keep in mind the tax laws? Are the corporate tax laws that we have important to you in consideration of whether you're going to take over a company or not?

Mr. PICKENS. Mr. Chairman, it's not an overriding factor, the tax aspects of these deals. I will say that it certainly gets some conversation in the overall evaluation process, but we do not make offers for companies because of the tax laws that we're working under.

Chairman PICKLE. Well, you do take into consideration—proportionately, we'll say—the questions of deductibility of interest, greenmail, net operating losses, those——

Mr. PICKENS. I'm with you except the part about greenmail.

Chairman PICKLE. Well, did I understand you to say that, with respect to greenmail, you would favor a corporation simply passing a bylaw that says they cannot pay money for greenmail?

Mr. PICKENS. That's right. I think that's the way to take care of it, just that managements are disciplined to the point where they're——

Chairman PICKLE. Now, in one or two instances you have been the recipient of "greenmail," is that not correct?

Mr. PICKENS. Would you tell me what those situations were, please?

Chairman PICKLE. Well, I'm just thinking in terms of the Phillips——

Mr. PICKENS. We didn't take greenmail in the Phillips deal. Mr. Douce is coming up right behind me; he can speak to that. We did not take greenmail. We got $53 a share and the other stockholders got at least $53 a share. There was no greenmail payment there.

Chairman PICKLE. Well, in any of your transactions, you say there's been no greenmail involved as far as you're concerned?

Mr. PICKENS. There was no greenmail in any of our transactions.

Chairman PICKLE. Well, that's interesting. I have a list of about 14 different mergers that you were involved in from 1982 through the present time, and the pretax gains have been in the neighborhood of $1 billion. None of that has been greenmail?

Mr. PICKENS. No, sir, it has not.

Chairman PICKLE. That's very interesting.

You do look at the Tax Code, but that's not your primary concern? Your concern is to make management more responsive to the shareholders, I presume that's what you're saying to me?

Mr. PICKENS. I'm saying that we have been sincere in our efforts in most of these instances—well, in all of them that we have tried to take over, we wanted to take over the company and run the company. And it just so happens that the shareholders, when you have an active, large stockholder in these companies, that all the shareholders are going to prosper by it. Now, I'm not telling you that I'm altruistic to the point that we're in here doing nothing but trying to work for stockholders; that's not so. We would like to make money, but all the stockholders make money on the deal. We've never talked to management about greenmail.

Let me make one point on this. We have been offered greenmail on numerous occasions, and even in the Phillips deal we were offered greenmail several times and we turned it down.

Chairman PICKLE. If you enter into the takeover process, you say you want to run the company. Have you ever taken over any company in these listings?

Mr. PICKENS. Yes, sir.

Chairman PICKLE. Can you give us a list of the companies you've taken over?

Mr. PICKENS. We've taken over Hugoton Production Company in 1969, Pubco in 1973, and if you're going to start in 1982 you would have to start, I suppose, with the Cities Service deal. Remember, Cities Service made an offer for us first. Ours was a countertender offer, but we did intend and wanted to——

Chairman PICKLE. Well, I was under the impression that you, in recent years—the last 4 or 5 years, or 4, let's say—that you really haven't taken over any. You have caused the stock to increase, but you've never taken over any of these companies.

Mr. PICKENS. Well, there are four companies over the period that you are talking about. That would be Cities Service, General American, and Gulf, plus Phillips.

Chairman PICKLE. Well, do you feel, in trying to make management more responsible, do they respond in that manner? Do they become more efficient or less efficient? Do you think that the threat of takeover is the best weapon to use to make them responsive?

Mr. PICKENS. Could I take a minute to answer that?

In the Cities Service deal, when we bought stock in Cities Service I believe the quote of their chairman was, "buzz off." I don't know; that seemed to me to be a peculiar statement to make to a stockholder. And in the General American deal, they never responded to us. But Phillips topped our offer there. In the Gulf deal, they said, "We're going to strap on our six-shooters and go after this guy," which I guess means they were going to come after me and shoot me. In the Phillips deal there was very little communication back and forth there. They did respond, but the response I just got in the hall from Unocal's chairman was that he wouldn't shake hands with me. And we were his largest stockholder, which I find to be an unusual attitude toward stockholders.

I would say, in a short answer, they have been basically unresponsive.

Chairman PICKLE. I said in my beginning statement that the Tax Code is not neutral because in at least four or five instances we know that, to a varying degree, the Tax Code could be used to help these mergers and these acquisitions.

Now, if Congress were to find a way to make the tax code neutral in these mergers and acquisitions—that is, make adjustments in section 337 or 338, either one or both, and also making some adjustment in net operating losses and the different treatments of debt financing versus equity financing—do you think that would help corporate management become more entrenched?

Mr. PICKENS. I do. I don't understand why you want in any way to impede this process that's going on because when a little guy from Amarillo, TX can be involved in four deals that make over $3 billion in taxes for the Government, surely it should be allowed to continue because I can't see anybody that is being hurt by it.

Chairman PICKLE. Well, you say that if we were to find a way to make the Tax Code neutral, your answer is that that would just make management more entrenched——

Mr. PICKENS. Well, when you say neutral——

Chairman PICKLE [continuing]. Then aren't you saying, Mr. Pickens, that the Tax Code is currently slanted in your favor and helps you in your efforts——

Mr. PICKENS. No, I don't think——

Chairman PICKLE [continuing]. To try to gain control of these companies?

Mr. PICKENS. Well, when you say slanted, you could certainly change it to where it would not be like it is today.

Chairman PICKLE. Yes, but you said you don't want them to be neutral. Then it must be in your favor now.

Mr. PICKENS. Well, let me back up, then, on my answer that neutral—I think that anything that you do to change the Tax Code is further going to entrench entrenched management. I prefer that answer over the one I just gave you 2 minutes ago.

Chairman PICKLE. Well, I thank you.

I've gone over my time, and I want to recognize Congressman Rangel.

Chairman RANGEL. Well, Mr. Chairman, there must be something terribly wrong here, I guess that's what we're looking for. Honestly, I've been persuaded by your testimony. We can't find out what it is, so let's try again.

Your primary desire, of course, is to enhance the financial position of your corporation. At the same time acquire or merge with some other outfit and improve their management and their stockholders' posture. This is your objective.

Now, how many times have you tried to do this and how many times have you been successful? In talking with our chairman you mentioned four acquisitions, of which the Government was the beneficiary of enhanced revenue. How many attempts have you made since, say, 1980?

Mr. PICKENS. Since 1980?

Chairman RANGEL. Yes.

Mr. PICKENS. Four

Chairman RANGEL. And each time you've been successful?

Mr. PICKENS. We've been successful in enhancing stockholder value, yes.

Chairman RANGEL. No, no, no. I meant to take over the company.

Mr. PICKENS. No, we have not taken over a company.

Chairman RANGEL. Well, how many attempts have you made to take over a company and how many companies, in fact, were you successful in taking over?

Mr. PICKENS. Do you mean from 1980, or since inception?

Chairman RANGEL. Well, since 1980.

Mr. PICKENS. OK. We have tried four, to take over four companies, and we have not taken over any of those four companies.

Chairman RANGEL. In each of those companies, even though you said you didn't receive green money, was your stock repurchased by the management at a price that was higher than what you purchased it for?

Mr. PICKENS. Well, let me explain, though, that in the Cities Service deal, Gulf topped our offer. Remember that Cities Service offered for us first. We countertendered. We had an offer for $50. Gulf came in and offered $63, and then took us out at $55, which was $8 under what the Gulf offer was. Gulf later backed off the deal and the company sold out to Occidental for $55. There was no greenmail there; we actually went out $8 under Gulf's offer.

The second deal was General American. We offered $40 for it. Phillips came in and topped us at $45. We went out, just like all the other stockholders, at $45.

In the Gulf deal, we made an offer at $65. Chevron topped it at $80, and all the stockholders went out at $80.

In the Phillips deal, both the Mesa partners and the other stockholders went out at $53.

Chairman RANGEL. How do you acquire the moneys necessary to make these offers in terms of stock purchase?

Mr. PICKENS. We borrowed 100 percent of the money in each one of those deals on Mesa's assets.

Chairman RANGEL. We have been concerned and received testimony that in some—and I thought most—of these deals, the acquiring company—since you're here, we won't call you "hostile" or "raiders" or anything, but yesterday that's what they were calling you; not you in particular, but that this money was borrowed on the assets of the so-called "victim" corporation. One of the major incentives that was provided was because you could write off the interest of this debt.

Mr. PICKENS. That's absolutely not so. Can you see me going into a banker and telling him I wanted to borrow on Phillips' assets? Why, he'd throw me out. We go in and borrow on Mesa's assets and they look solely to those assets for the repayment. It's amortized out of the cash flows from those properties, and that's exactly where the funds come from.

Chairman RANGEL. Well, that's one of the reasons I want to thank you for coming here since you're actually involved in this.

I know it's your position that we should not tinker with the Tax Code as relates to mergers and acquisitions because it's your belief that only improvement is made. This is the free marketplace. Just let me ask that if, for mergers, the deductibility of debt interest were not allowed, would you think that this would have a severe impact on mergers and acquisitions?

Mr. PICKENS. I think it would probably change the value of some of the companies that are involved and the price would come down, and the mergers and acquisitions would start at another level.

Chairman RANGEL. When you review a company that has been targeted for possible takeover, do you take a look at the net operating losses of that company? Is that a major factor?

Mr. PICKENS. That's not a factor at all because we don't look at companies that have operating losses.

Chairman RANGEL. Do you know of any major takeovers that were started for the sole purpose of acquiring stock and selling the assets and repaying the loan. The reason I ask that, Mr. Pickens, is that we had three or four Senators here yesterday who violently opposed existing law because they were talking about—and I assume they were not talking about hypothetical examples where the company that sought to acquire another company borrowed a lot of money based on the assets of—they would say "victim" corporation; after acquiring it, they would sell off, liquidate, wipe out the limited productivity that this company had and increase their profits. When it was all over, the giant having eaten up the smaller company, this situation left the community with less jobs.

Now, in your business and with the people you talk with, do you hear examples of that occurring?

Mr. PICKENS. I don't know of any examples.

Let me make a point here that I've been identified as a "liquidator" and there isn't anybody that can show me where I've either taken greenmail or where I've ever liquidated anything. We started in 1956; Mesa Petroleum's predecessor company had $2,500 paid-in capital, and today we have about $4 billion in assets. We're the second largest independent oil company in the United States. That doesn't look like a liquidator.

So I don't know of any situations where somebody came in and gobbled up and victimized the company and all.

I have to go back to one point, that if the stockholders do not want to take an offer for a company, they don't have to do so. The stockholders own the company. Now, we get a little confused sometimes in talking about companies as to who really does own the company, whether it's the management of the company or whether it's the stockholders of the company. I come strictly from a stockholder's viewpoint. Stockholders own the companies. If managements do well for stockholders, everything works out fine.

Chairman RANGEL. Well, I don't think the Senators argued with that. There was some question as to whether or not the stockholders really had all of the information available to them to make a sound decision. I don't argue with you that that is basically their decision.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman. Thank you, gentlemen.

Mr. Pickens, you have been sort of described as the "master of greenmail" and now you're telling us that you have never taken greenmail in your life. Is that true?

Mr. PICKENS. I swear to you, I've never taken greenmail in my life.

Mr. SCHULZE. Well, that's good, because that's the only area I could see some kind of legislation addressing. It's very difficult for me to rationalize how a raiding group should be paid more for their interests than the ordinary stockholder.

Mr. PICKENS. I couldn't agree with you more.

Mr. SCHULZE. But your solution to that would be for either the corporation individually to pass a resolution within, or for the State to enact some law. What's your suggestion?

Mr. PICKENS. You don't even have to have a law. All you have to do is just for the board of directors to say, "We're not going to pay any stockholder a premium to market that's not offered to all stockholders."

Mr. SCHULZE. I understand that your suggestion is picking up speed, and now there are 200 or 300 corporations that have taken that route. Do you think that practice will be followed sufficiently so that Congress won't have to legislate in that area?

Mr. PICKENS. I think you're getting ready to see an end to greenmail. I think we're coming down to a point where managements are going to be too—they just won't have the guts to pay somebody greenmail.

Mr. SCHULZE. You used the term "entrenched management" two or three times. When you are looking at a target for acquisition, do you look for "entrenched management"? The term conjures up in my mind people who have been there for a long time and are protecting their own little turf. The type that really doesn't care about the stockholders or the others, only about their positions and their retirement. Am I getting the correct imagery?

Mr. PICKENS. Well, I think when we look at a company, it's not so much that you look at a management, that maybe they're entrenched. I think that the performance of the stock in the marketplace will give you a pretty good profile as to what kind of management you have. So when you have a stock price that is selling at a

deep discount to the underlying values of the company, you will find that usually the management looks a lot like the stock price.

Mr. SCHULZE. If I'm correct, you said that the stock of the 10 largest energy companies is undervalued by $75 billion?

Mr. PICKENS. No. What I said was that if you'll take the underlying values, the appraised values, of those 10 companies, and if those managements could raise the price of their stock to 75 percent of the appraised value, it would be an enhancement to 4 million stockholders of $75 billion.

Those 10 companies are actually selling today at approximately 45 percent of appraised value.

Mr. SCHULZE. Is that typical of energy companies or is that true across the board in corporate America?

Mr. PICKENS. It would be unfair for me to comment about other industries because I'm just not that well versed in those. I can say that the larger companies in the oil industry are selling at a deep discount to appraised values for one reason—because the marketplace is reflecting what they believe that management is going to do with those assets.

There's another urgency here as far as energy companies are concerned, that none of these 10 companies is consistently replacing their reserves of oil and gas, which is the primary asset of the stockholders.

Mr. SCHULZE. Perhaps Mr. Andersen could reflect on other industries, other than the energy industry.

Mr. ANDERSEN. It's very difficult to comment across the board. The energy industry is easy to value on an evaluation basis because you have a free trading market, or a relatively freely-trading market, for their reserves. It would be very difficult to figure out the value of the reserves in a computer company or a software company or something like that. Your evaluation criteria just are not the same.

Mr. SCHULZE. So it's easier to evaluate an energy company because of its reserves or potential reserves, and you can actually put a dollar figure on it?

Mr. ANDERSEN. It is much easier because there's a market out there that quotes those kinds of assets and there are more trades that take place in those kinds of assets. All you're doing in the energy companies is evaluating the sale or the value of the reserves versus the selling price of the reserves versus the finding cost of the reserves versus the public market price. If you find other industries with similar kinds of characteristics, you can do the same sort of analysis with equal confidence and flexibility.

Mr. SCHULZE. Mr. Pickens, has Mesa Petroleum made more money in the oil and gas business or from takeover attempts over the last 4 years?

Mr. PICKENS. It's made more money out of takeover attempts.

Mr. SCHULZE. Is your stock undervalued like everybody else's, or is it overvalued?

Mr. PICKENS. If you take the same yardstick, and we all look at John S. Herold's evaluations, Mesa is selling at 100 percent of appraised value today.

Mr. SCHULZE. You're not a target for——

Mr. PICKENS. We're probably not a target—that's right.

Mr. SCHULZE. Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Guarini?

Mr. GUARINI. Thank you, Mr. Chairman.

Mr. Pickens, you obviously have a criteria that you use and information you must acquire before you make a decision. Could you share with us what your criteria is and how you find this information?

Mr. PICKENS. Well, the information is public information. We work totally from public documents.

Mr. GUARINI. But if a company is hostile to you, won't it be much more difficult to dig out the information?

Mr. PICKENS. No, it's available through annual reports and 10K's and other analysts' reports and all. It's all there.

Mr. GUARINI. In other words, you don't feel that there's any inside information or special information that you have to have to make a business decision on whether to target or raid a company, other than what you can find out from Dun & Bradstreet or Merrill-Lynch?

Mr. PICKENS. What we use more than anything else, of course, is the 10K's, the filing with the SEC.

Mr GUARINI. Right. So therefore, no special information has to be available other than what is made public already—

Mr. PICKENS. We've never had anything but published information.

Mr. GUARINI. All right.

Now, do you search for companies that do not pay taxes or that have NOL's so that you can take advantage of the tax percentage?

Mr. PICKENS. That's never been a factor, a company's tax position, as I recall.

Mr. GUARINI. Are you saying that is never a consideration, or that is a minor consideration?

Mr. PICKENS. Well, it's never been the driving force to do a deal. We naturally are going to become familiar with the company's tax position.

Mr. GUARINI. Well, then, what are the higher levels of criteria that you do use when you make a decision?

Mr. PICKENS. Primarily in our industry, it would be the reserves, the domestic reserves of oil and gas.

Mr. GUARINI. You're just confining it to the geological oil reserves of oil companies?

Mr. PICKENS. That's right. Well, you know, from 75 percent to 90 percent of the value in an oil company in the United States will be found in the domestic reserve base.

Mr. GUARINI. You've stated, I understand, and it's a quote, "It has become cheaper to look for oil on the floor of the New York Stock Exchange than in the ground"?

Mr. PICKENS. I've never said that.

Mr. GUARINI. This is Times magazine quoting you.

Mr. PICKENS. I know, but it's erroneous. I did not make that quote.

Mr. GUARINI. Do you believe that that quote is wrong?

Mr. PICKENS. I did not say that.

Mr. GUARINI. Do you believe the fact that you can find oil——

Mr. PICKENS. I don't like the quote because I don't think you look for oil on Wall Street or the New York Stock Exchange. I'll just tell you what I feel my responsibilities are at Mesa Petroleum. I'm paid to do the best I can with the capital I have available to me, and I'm going to put that money into whatever we can do to get the best return for our stockholders. And we drill a lot of oil wells and we drill a lot of gas wells and we're a very active exploration company. At the same time, we have generated quite a lot of cash flow and we see other places that we want to put that money.

Mr. GUARINI. Well, I've heard it said that people in America's boardrooms use too much of their time trying to put together deals and mergers and acquisitions, expending their energies and talents in that direction rather than making their company more productive. Is that a fair or an unfair statement? Could you comment on that?

Mr. PICKENS. Well, I don't know what other companies do in their boardrooms. I know we do a very good job of making our company productive. We started out with $2,500 and we have $4 billion in assets today, which was about 25 years ago, so the company has done very well and our stockholders have done well. We sell at 100 percent of appraised value.

Mr. GUARINI. Well, you say that you do this by better management; is that correct?

Mr. PICKENS. I'd say our management has done a very good job.

Mr. GUARINI. Now, when you take over a company, do you change the board? Do you change the CEO of a company, necessarily?

Mr. PICKENS. Well, we haven't taken over a company since 1973. In 1973, when we took over Pubco. We offered 90 percent of those employees a job with the company. I don't remember what percentage went with us. In 1969, when we took over Hugoton Production Co. we did change the board. Some of their members came on our board at that time. And we offered everybody in that company a job.

Mr. GUARINI. May I ask, are you a professional CEO in managing a company? Not that you've had any experience, but is your background in business and management of companies? Or is your background rather as a geologist?

Mr. PICKENS. I'm a geologist by education, a graduate of Oklahoma State University with a B.S. degree in geology. I worked for Phillips Petroleum Co. for 4 years and then went out on my own, and then formed Mesa Petroleum's predecessor in 1956 and we went public as Mesa Petroleum in 1984.

Mr. GUARINI. So your strength basically is putting business deals together, not managing or administering corporations as a CEO; is that correct?

Mr. PICKENS. Well, I founded this company in 1964 as a public company. I've managed it ever since, so I would say that qualifies me as a manager of an oil company.

Mr. GUARINI. Well, are you the president of the company or chairman of the board?

Mr. PICKENS. Yes, I'm CEO.

Mr. GUARINI. Do you spend most of your time working on mergers and acquisitions or do you spend your time on the productivity of the company of which you're the chief executive officer?

Mr. PICKENS. Well, I'm the chief executive officer of the company, and I took over the exploration and development portion of the company again when our executive vice president retired in July 1984, and we had the lowest finding cost in our exploration division in 1984 since 1978. So I actively look at oil and gas prospects, and I'm very much involved in our merger and acquisition activity.

Mr. GUARINI. Would it be possible to separate the time and energies that you spend as an administrator of your company as compared to the time and energies you spend in seeking out new mergers, new acquisitions, new business deals, raiding other companies?

Mr. PICKENS. My wife kept the amount of hours that I worked one time over a 6-month period, and she said, "You work 80 hours a week." So I guess I can put 40 hours in on mergers and acquisitions and 40 on exploration and development activities.

Mr. GUARINI. So half your energy is spent on mergers and acquisitions? This is a major part of your thrust?

Mr. PICKENS. Well, we're trying to do the best we can with the capital we have available to us, so we do try to acquire reserves from time to time.

Mr. GUARINI. OK. No further questions.

Chairman PICKLE. Thank you.

Mr. McGrath?

Mr. MCGRATH. Thank you, Mr. Chairman.

Welcome, gentlemen.

Mr. Pickens, do you attempt only to acquire companies where you have an expertise in the field to manage, or do you attempt to acquire to diversify your holdings?

Mr. PICKENS. No. The companies that we have attempted to acquire have been oil and gas producing companies.

Mr. MCGRATH. We're seeing a lot today in mergers and acquisitions of communications companies, and certainly you've articulated well the reasons why oil companies, in terms of their reserves and undervalued stock, why those companies would be ripe for a takeover. How about communications companies at this point? Why is it looking like communications companies are more and more becoming targets of takeovers?

Mr. PICKENS. I don't know.

Mr. MCGRATH. How about you, Mr. Andersen?

Mr. ANDERSEN. I think that you've recently had some changes in the structure of the communications industry. Also there have been a number of transactions in stations, in newspapers, and in periodicals, so that the assets are relatively easily valued. With the change in the number of stations that can be owned by a single corporate entity, there came about a substantial turn over in station ownership. That has caused a lot of people to develop a great deal of expertise in the communications business in evaluating the values of these assets. That caused people to focus on the values of the assets as they are presently being managed, and the potential values of the assets are if they were to be acquired by other managers: which are the alternative ways to come in control of them.

And that has caused people to focus on that industry at this particular point in time.

Mr. McGRATH. So really, determining the value of the assets is——

Mr. ANDERSEN. It goes back to what I tried to say at the conclusion of my earlier remarks, that the basic, fundamental reason why this whole market exists is that there is a difference in values between two market places, some nonpublic market and the value of the public market. And the way you eliminate this entire problem is exactly what Mr. Pickens said—get the stock price up so that there isn't a differential between these two markets, then there is no profit opportunity and no entrepreneur is going to go out to try and create the value differential. That's what drives the whole market. So if you value the assets and you find that the assets are worth more in this market than they are over here, somebody is going to buy them here and try to sell them over there, as opposed to going over to buy them here and trying to sell them over there.

Mr. McGRATH. Thank you.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

Mr. Pickens and Mr. Andersen, I appreciate your testimony very much.

I don't start out with any preconceived ideas about changing the Tax Code. I think we're just trying to find out what's going on and see whether or not any changes should be made.

You tell us that the reason that all this activity is going on is because there are companies whose stock is undervalued in the market for some reason, and I'd like to probe that a little if we could.

The market, the New York Stock Exchange and others, have always been suggested that they were the most efficient market for determining value for common stock. What makes—could you tell us what makes the difference in the valuations if it is not taxes, as you indicated? How do you account for the difference in valuation of the underlying value in that supposedly very efficient stock market?

Mr. PICKENS. Well, what the stock market is reflecting, as far as oil and gas companies are concerned, is that the investing public doesn't believe they're worth any more than the price they're selling for in the market place with the present management that they have. They don't believe that the management is going to do anything for the stockholders.

Mr. FLIPPO. In looking at those companies, then, management, I believe, is one of the prime differences that you suggest as a reason for an undervalued company. If you had taken over some of those companies, could you tell us some of the things you would have done to improve the value of the stock?

Mr. PICKENS. Well, I think that the best thing I can do is just to go back to our record where it is, at Mesa Petroleum, and look at that. And we have realized full appraised values for our stockholders, and we believe that we could employ those same management techniques to something that we might acquire.

Mr. FLIPPO. Well, is it a fair statement to say that all of the companies that you've looked at as takeover candidates have been profitable companies paying significant income tax, current tax?

Mr. PICKENS. I would say they are paying taxes. I'm sorry I can't tell you—I don't know what you mean by "significant", one, but I don't know what their tax rate was.

Mr. FLIPPO. Well, I guess what I'm trying to get to is that it appears that market values go up when the stockholder can expect an increased return on his investment. And he can expect an increased return on his investment by certain actions of management, including the increasing of debt for a corporation—the substitution of debt capital for equity capital can increase the tax deductions, thereby producing greater cash flow. Management can, in fact, increase the return on equity to the shareholder by substituting debt for equity.

In other words, some of the complaints about the problem is that these mergers cause companies to increase debt substantially, producing more cash flow to amortize the debt and at the same time pay a higher rate of return to the shareholder. Is that the method that is used in a good many cases to increase the return to a shareholder?

I don't believe that I go along with that, that you increase debt and you also increase cash flow. I believe that's what you said.

Mr. PICKENS. Yes. I think that can be demonstrated, that you can increase debt and, at the same time, increase return to the stockholder because debt is deductible and the equity capital is not. But I think you're going to get a better answer from Mr. Andersen on that.

Mr. ANDERSEN. I think that you're making a basic assumption that the management is in charge of those assets is earning a rate of return on the equity which is in excess of the rate that it's paying on its debt, and that is not always the case. If what you're saying is true and you carry it to the logical extreme, every company would try to finance itself with one dollar of equity and all the rest debt, and that dollar of equity would reach the highest market value for equity. That's not the case. You have to have a management that will earn a rate of return; you have to have a capitalization that the shareholder believes is a justifiable capitalization for that amount of debt, and that creates the optimum level of leveraging for a given capitalization.

Mr. FLIPPO. Well, since I'm out of time, I really would like to pursue it but I can't. But I did want to suggest to you that, in fact, what many people are very concerned about, is increasing debt. You and I may have a good theoretical discussion sometime on what the proper debt to equity ratio is, but that is the concern that many people are expressing—that debt is being increased to increase the cash flow over and above what is necessary to amortize that debt, and to increase a return to the shareholder. And that's why the stock price is going up, but there's really no different economic circumstances that exist, is what the complaint is. That's what I was trying to get to, but I appreciate your testimony and I hope we'll have a chance to discuss it at some further time.

Chairman PICKLE. Mr. Frenzel, do you have a question?

Mr. FRENZEL. Thank you, Mr. Chairman.

I want to thank both the witnesses for their splendid testimony.

Mr. Pickens, on page 14 of your testimony and your later discussion you talk about what has come to be called greenmail. You define it and tell us it's not a good thing, and you later told us in discussions that you don't like the use of it and you've never gotten any. However, in your testimony you prefer that we do not legislate against greenmail even though you don't like it. Could you amplify that? Are you just afraid that we're going to legislate in a sloppy way and prohibit some useful device?

Mr. PICKENS. Well, what I have seen on the legislation is that there are many things that are covered under greenmail. If you're going to legislate on greenmail, I'd just say to make it a one liner, that there isn't going to be any company pay a premium to market to any stockholder unless it's offered to all stockholders. And I think that's all the legislation you need. I don't think you need to put in anything other than that.

Mr. FRENZEL. I think that's a pretty good suggestion.

My bias is similar to yours about putting protections or inhibitions in the marketplace. I think that we can often be expected to do something wrong or complicate the marketplace at a time when we are intending to simplify it. At least, that has been our track record.

Do you have similar feelings with respect to the sale of the bonds that finance these purchases? There, I take it from your testimony, you would see no reason to legislate at all because that would unnecessarily inhibit free sales in a relatively free marketplace. Is that correct?

Mr. PICKENS. That would be my feeling.

Mr. FRENZEL. Is that the opinion of Mr. Andersen, as well?

Mr. ANDERSEN. I think my feelings probably go deeper on that subject than Mr. Pickens'. I think that if you do anything to stop the free flow of credit in the marketplace, what you're saying is that the only people who can buy companies and make acquisitions are the large companies, who have proven themselves to be relatively inefficient creators of jobs and inefficient in the utilization of capital in many instances. The people who are financing these acquisitions, and who need access to these credit markets, are the smaller and medium-sized companies who need capital for their growth.

Mr. FRENZEL. I thank both gentlemen for their testimony.

Mr. Chairman, I yield the balance of my time.

Chairman PICKLE. Thank you, Mr. Frenzel.

The House has a vote underway now, and the second bell has rung. We will recess for approximately 10 minutes, and then we will recognize Mr. Anthony; and then, we have visiting with us Mr. Jones, your colleague from across the border, who is a member of the full committee and who asked permission to interrogate the witnesses. So we'll recess for approximately 10 minutes.

[Recess taken.]

Chairman PICKLE. The Chair would ask everyone to please take their seats and we'll resume the hearing.

I believe Mr. Anthony is to be recognized next. Mr. Anthony?

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Pickens and Mr. Andersen, I want to welcome you before the committee. Since my time is short, I'll try to get straight to the point.

Mr. Pickens, what do you suggest I say to my sawmill worker who pays his taxes through weekly withholdings at a higher rate than Mesa Petroleum is paying on its enormous income? I understand that you haven't paid any tax for the last 3 years.

Mr. PICKENS. The reason for that is because we have huge loss carryforwards from very large budgets for exploration and drilling in prior years. For instance, in 1981—let's go back to 1980. We had a drilling budget in 1980 of over $400 million, and our cash flow was $200 million. So we were actually borrowing half of our money to fund our drilling and exploration budget. The same situation was in 1981. We did not get in balance, as far as cash flow to exploration, until 1983; consequently, those cash loss carryforwards were building up in those years of 1980, 1981, 1982, and 1983. We started to get in balance as far as our expenditures are concerned. I'm not that familiar with our tax return, but in 1984 we were substantially under our cash flow on drilling and exploration, which started to use those tax loss carryforwards. And so they were being used up rather fast in 1984.

Mr. ANTHONY. So to summarize, you suggest that I should tell my sawmill worker to buy a bunch of loss carryforwards so that he could——

Mr. PICKENS. No; it was actually for exploration.

Mr. ANTHONY. How much of your exploration went into research and development expenditures?

Mr. PICKENS. We didn't have—other than some geophysical work, we didn't have much go into it. But I might tell you about a number that would be interesting to you on the Outer Continental Shelf. From 1973 to 1983, we spent $1.8 billion in the Outer Continental Shelf.

Mr. ANTHONY. How much did your company spend in alternate energy expenditures from 1980 through 1984?

Mr. PICKENS. We didn't have any alternate energy projects.

Mr. ANTHONY. And you didn't have any research and development expenditures.

What is Mesa Petroleum's batting average as compared to the average of the industry when it comes to return on exploration and development of assets, return on petroleum assets, and the finding and development dollar costs per barrel?

Would you say it's above or below the average of the industry in those three areas?

Mr. PICKENS. I don't know what the average is. I can tell you what it was in 1984, that our finding cost was under $7 a barrel onshore, and offshore it was $10 a barrel.

Mr. ANTHONY. Well, I understand that you're trying to take over Union Oil and you're doing so to competently and efficiently manage the assets of Mesa. Therefore you're saying that Union Oil is undervalued and basically this company is not managing their assets properly. And their stockholders could benefit from a takeover by Mesa.

But when you look at those three categories that I previously mentioned, Union Oil has a much greater, outstanding record than

Mesa does. So I'm challenging your management ability in those five areas as opposed to Union's.

Mr. PICKENS. May I speak to that, please?

Mr. ANTHONY. Yes, I'll let you speak.

Mr. PICKENS. OK. On return on common equity in 1984, Unocal had 13 percent and Mesa had 50 percent. On finding costs in 1984 per barrel, Union had $10.30 and Mesa had $10.90. On oil shale development costs, which is no commercial production to date, Union Oil Co. had spent $1 billion and Mesa had spent zero. Shareholders' equity increase in 1984 was 10 percent for Unocal and 48 percent for Mesa. Not a bad record.

Mr. ANTHONY. Not a bad record. Is Mesa under any restrictions from your bankers as to whether or not you can raise your dividend to the current stockholders on a quarterly basis, and are you under any restriction from your bankers of selling assets valued at more than $10 million without the bank's permission?

Mr. PICKENS. I'm not that familiar with our loan agreements with our banks.

Mr. ANTHONY. If I told you it's my information that you cannot raise your dividend by more than 10 cents a quarter and that you cannot sell more than $10 million in assets without the bank's permission, would that shock you?

Mr. PICKENS. It probably wouldn't. But do you feel like 10 cents a quarter would be a kind of a meager increase?

Mr. ANTHONY. Well, if I were a stockholder I'd want it to be a dollar a quarter, personally.

Mr. PICKENS. Well, you should tell Mr. Hartley that when he comes up because he raised his dividends yesterday, 5 cents.

Mr. ANTHONY. I'll ask him.

Mr. PICKENS. Only 5 cents.

Mr. ANTHONY. I'll ask him. And I am sure he did this as a defensive measure, I'm sure, against you.

Mr. PICKENS. Well, now, we appreciate it because it helps our interest carry.

Mr. ANTHONY. What I would ask you to do, if those figures are incorrect, to correct them for the record.

Mr. PICKENS. I'll be glad to see that they're corrected.

Mr. ANTHONY. And if they are correct, I wish that you could verify that for us.

Mr. PICKENS. The questions are that we can't raise our dividend more than 10 cents a quarter? Is that one?

Mr. ANTHONY. And whether or not you can sell assets valued at more than $10 million without the bank's permission. And the reason I'm asking this is because you keep making statements about helping the stockholder; and yet, your own stockholders' future is wrapped up in the benevolent wishes of some banker as to whether or not you can raise the quarterly dividends or whether or not you can sell some assets to raise more capital in order for you to go manage somebody else's business more efficiently than you say they've been doing.

Mr. PICKENS. I'll stand on the record that we're selling at 100 percent of appraised value, and I don't find that——

Mr. ANTHONY. Well, I'm glad you said it that way, because that led me right to my last question.

Mr. PICKENS. Good.

Mr. ANTHONY. What if I go down to the sawmill and I say to the sawmill workers, "You're paying more taxes as a percent of your income than Mesa is, but they're doing it legitimately because we've put some tax breaks in there for them and we just haven't put them in there for you, other than that you can write off the interest on your consumer debts and you can write off the interest on your home mortgage if you want to." But what if I told that sawmill worker, in order to treat them more fairly and to lower the deficits that we're running, that we're going to take away the interest deductibility of Mesa's takeover effort? What would Mesa say to that?

Mr. PICKENS. Well, when you said that we had special considerations as far as taxes are concerned, to your sawmill worker, your sawmill worker—if he wants to drill wells and create loss carryforward, there's no trick to doing that. And that's exactly where our loss carryforward came from.

Mr. ANTHONY. What if I told the sawmill worker we were going to take away your interest deductibility, that we were going to treat equity and debt the same? What would Mesa's position be? What would happen to Mesa if we did that?

Mr. PICKENS. We'd still be around as an operating oil and gas company. We've been here for 20 years. We've adjusted to a lot of things, changes in the Tax Code. I mean, it isn't something——

Mr. ANTHONY. So you could adjust to this one?

Mr. PICKENS. We can adjust to whatever happens to us, I can assure you of that.

Mr. ANTHONY. And you will survive if we make that change?

Mr. PICKENS. And I'll tell you one thing, we won't run to Washington to ask them to change the Tax Code or to ask them for protection or whatever else.

Mr. ANTHONY. I'll remember that.

Chairman PICKLE. Mr. Pickens, you also said to me earlier, when I said should we make the Tax Code neutral, neutral with respect to these takeovers, you said no, that would be a mistake. And I assume from that that the Tax Code must work in your favor, and it does. But you don't want Uncle Sam to have anything to do with protecting corporations—you won't come to the Federal Government asking for help. But it seems to me, if I understand what Mr. Anthony asked you at the very beginning, and I was interrupted, perhaps I misunderstood you—tell me, you paid a tax rate of what, this last year, you said 1 percent?

Mr. PICKENS. That's what Mr. Anthony said.

Chairman PICKLE. Well, I'll ask you; what did you pay?

Mr. PICKENS. I don't know what our rate was, Mr. Pickle. I'll be glad to make that a part of the record.

Chairman PICKLE. You, the CEO, and the hottest thing in American finance, you don't know what corporate tax you paid last year?

Mr. PICKENS. I answered the question. I don't know.

Chairman PICKLE. Do you know for—that would be 1983. Do you know what your tax rate was for 1982?

Mr. PICKENS. Or 1981 or 1980 or 1979 or 1979—no, sir, I do not know.

Chairman PICKLE. Well, Mr. Pickens, we will find that out. You don't have to tell us. We'd be glad for you to, but we can find that out. That's a matter of record.

Mr. PICKENS. Would you rather I not give it to you, Mr. Pickle, or would you want to find it out on your own?

Chairman PICKLE. If you don't know it, I'll have to accept that. If you don't know what your rate was, I'll have to accept that. And I do, except I will add that it's very strange that a corporation worth $1 billion doesn't know whether you paid a 1 or 2 or 3 or 10 percent.

And that type of thing causes a lot of people to ask themselves, I think, Mr. Pickens, "Well, if here's a corporation worth $1 billion, and it made $1 billion profit in these kinds of takeover attempts the last 3 or 4 years, and you haven't paid any Federal tax," then a lot of people are saying, "Why should I pay tax?" And it raises the question that perhaps we ought to have a minimum tax. Would you recommend a Federal minimum tax?

Mr. PICKENS. Mr. Pickle, I said from the outset that I'm not an expert on taxes. I said I knew something about the oil and gas business, so I'm not here as a tax expert.

Chairman PICKLE. Well, we'll come back to that. I just couldn't help observing.

Now, who was next on the questioning? Mr. Dorgan?

Mr. DORGAN. Yes.

Chairman PICKLE. And then Mr. Jones, we'll recognize you.

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Pickens, I'm curious. In the annual report of Mesa it indicates that its intention is to stick to business and to acquire oil and gas reserves, and yet you indicated a while ago that in the last 4 years or so your profitability from attempted acquisitions is greater than your profitability from other ventures, such as oil and gas exploration. Is that an accident, or is that a business strategy on your part?

Mr. PICKENS. Well, we were trying to make acquisitions and we were unsuccessful in acquiring anything. We did make money, and so did the other stockholders.

Mr. DORGAN. I understand that. But if you're involved in a process in which losing is winning, does not that become a business strategy at some point?

Mr. PICKENS. No, it hasn't as yet.

Mr. DORGAN. Do you consider that you lost in the four attempted acquisitions, or do you consider——

Mr. PICKENS. We wanted to make those acquisitions, and we were unsuccessful.

Mr. DORGAN. But your responsibility to your stockholders is to make money. You in fact made a lot of money in those aborted attempts, or in those unsuccessful attempts. Do you not consider yourself a winner?

Mr. PICKENS. We didn't lose, I'll say that.

Mr. DORGAN. OK. So if you consider yourself a winner, is that becoming a business strategy for Mesa?

Mr. PICKENS. We have not had a business strategy to try to make money out of the stock market. What we've tried to do is to acquire companies, and in losing, we have made money, yes.

Mr. DORGAN. We've not had the chance to meet, and I have to confess that I enjoy reading about what you do. But I also get the feeling, when I read some of the quotes, and I accept the fact that some of them are going to be accurate, that you kind of enjoy this whole area of winning through losing and that this seems to become your business strategy. Is that perception wrong?

Mr. PICKENS. I'll just have to answer it the same way I have the last three times.

Mr. DORGAN. OK. Let me ask you a question about the subject of acquisitions and mergers, and also correct a statement you made. You indicated that there are a bunch of corporations that would like to see us restrict the deductibility of interest on debt acquired for acquisitions and that that's where the impetus is coming from. I introduced a bill over 3 years ago to do just that, and I don't have any truck with businesses or CEO's; I have never talked with them about it, as a matter of fact.

Are there conditions under which you might be concerned about the level of merger activity in this country? And if so, could you describe those conditions?

Mr. PICKENS. I don't have concern.

Mr. DORGAN. Did you ever play monopoly when you were a kid?

Mr. PICKENS. Yes, I did.

Mr. DORGAN. You talk about the stockholders a great deal. When you played monopoly as a kid, you understood that when you got ahold of park place and boardwalk, you were able to charge more rent? That had something to do with the consumers.

Do you think that in the process of analyzing business behavior, analyzing the merit of merger and acquisition activity in this country, and analyzing the competitiveness of the free market, do you think there is reason for policy makers to be concerned about the consumers?

Mr. PICKENS. No, I don't.

Mr. DORGAN. Mr. Baxter, who represented this Administration as the chief antitrust enforcement officer, said and confirmed it to me in a situation just like this, that if America were run by 100 corporations, each having 1 percent of the business, that would represent perfect competition and should pose no problems for policymakers or public officials. Do you concur with that?

Mr. PICKENS. I think that the reason why America is what it is today is because of the free enterprise system, so I believe you let the free enterprise system operate, and it has checks and balances in it. And as far as 100 corporations that has 1 percent of the business, I don't think it should be structured like that because it won't be long before you'll have entrepreneurs that will come into the situation and you'll now have 200 or 500 or 1,000. And that's what we want to encourage.

Mr. DORGAN. Does your concern and interest in the free enterprise system extend to the stewardship responsibilities some of us have—at least, as we understand it—to try and keep the free market system competitive? Or do you think the free market system will always be competitive in any event, so we needn't worry about that? Is that your position?

Mr. PICKENS. Well, from the areas that I'm involved in, I don't see that the free market system is in jeopardy anyplace.

Mr. DORGAN. I'm not necessarily surprised by your answers. I have obvious disagreement with some, but I was just interested in your perspective about mergers and acquisitions.

Let me ask a question on a different subject. You have attempted four acquisitions recently, failed—but one—and made a great deal of money. In what condition did you leave the victim corporation? Stronger or weaker? And could you describe the four targets?

Mr. PICKENS. Sure, I'd be glad to. I'd like to describe that, in fact.

The Cities Service deal, if you recall, they made the offer for us first, so we made a countertender offer. If we could have merged with the Cities Service Co., we said that we would move to Tulsa and live in Tulsa, run that company from Tulsa.

Now, if anybody had looked at the numbers of people involved and the size of the two companies, we would have had to do that because Mesa only had 650 employees and Cities Service had some 20,000 people, so it would be foolish that we could move Cities Service to Amarillo, Texas. I mean, it didn't make any sense, OK?

If we had merged with that company, I am confident that company would be a much more dynamic company than it was by the prior management or the management that got the company. It was acquired by Occidental. Now, I don't know what Occidental has done with Cities Service Co.

Second, the General American Co. is the one that we made an offer for, for $40. Phillips topped us at $45, and I don't know what Phillips has done with those assets, either. Had we acquired that company, we would have moved that company to Amarillo from Dallas because the company was slightly smaller than Mesa was.

The third company, Gulf—we said we would move to Pittsburgh, live there, run the company from there. The management of the company decided to sell out to Chevron. They had three options available to them. They could have done a royalty trust, which we suggested; the company would have been left intact with a royalty trust. It would have just meant that they had split off one quarter—one quarter of the cash flow to the stockholders. That was all. It didn't have anything to do with the employees of the company. The second option that they had was to do the leverage buy out that KKR offered them for $87.50. They turned that down. Before the Senate Judiciary Hearings Mr. Lee, the chairman of Gulf Oil, said, "If you don't let us go to Chevron, Pickens will take over in a proxy fight." Had we done that, we would have moved to Pittsburgh and the company would have been left intact.

The fourth option they had for them is, they went to Chevron. They went to Chevron.

OK. The last one is Phillips. And Phillips is intact, in Bartlesville, exactly where it would have been had we taken the company over. We would have moved to Bartlesville and run the company from there.

Mr. DORGAN. Is Phillips deeper in debt as a result of this?

Mr. PICKENS. Well, that to me is an interesting adjunct to all this. The debt that Phillips has acquired here—this company is a very, very strong company. They had a strong balance sheet, they were underleveraged, they had $2.5 billion in cash-flow. The company can handle the debt with no problem at all. It's not any problem to——

Mr. DORGAN. So you've done an underleveraged company a favor?

Mr. PICKENS. Wait a minute. The company is the stockholders, and the stockholders——

Mr. DORGAN. I understand that.

Mr. PICKENS [continuing]. Came out very well. The stock was selling at $37 when we bought the first share, and the company made a deal with the stockholders for $53. I think the stockholders came out very well. The stockholders think they came out very well. The company is still a very strong company, very viable.

Mr. DORGAN. Mr. Chairman, my time is about done.

I'd just like to say, Mr. Pickens, again, that I'm very interested in what you do. I read a lot about you; and we, in North Dakota, are interested in the way Texans comport themselves, and there's been plenty to read about that recently.

I am concerned about the general area of mergers and acquisitions. It has not just increased arithmetically, it has increased geometrically recently, and I think that necessarily restricts competition and necessarily increases bureaucracy in many of these companies. For the same reason that I am concerned about Government, I am concerned about the development of most of this country's manufacturing and production being controlled by the hands of a few. And I do think that we need to be concerned about it. I'm not suggesting taht all mergers are bad, but I don't agree with your position when you suggest that mergers create efficiency.

I would like to see us have people with your obvious talent pursuing the roads that Henry Kaiser pursued in this country's history and Henry Ford and others. There is a real tendency to grow through acquisition, to try and make money by trading paper. And I'm not sure that creates long-term real strength and jobs for this country.

Mr. PICKENS. Could I comment about that?

Mr. DORGAN. Sure.

Mr. PICKENS. The reason why these opportunities are there is because of weak management. That's the reason why it is. You're getting ready to make a more efficient system out of what we have in corporate America, and this is important. But when you say you wish I would pursue what Henry Kaiser did, I've pursued what Henry Kaiser's done. We've built a substantial oil company in Mesa Petroleum, and we still pursue exploration and development projects, aggressively we do. But still, we have to stay in this business and do the best we can with the capital we have available to us. And when we see opportunities, then we take advantage of them.

Mr. DORGAN. In your opinion, how do you describe yourself as a manager and the management of Mesa as opposed to IBM?

Mr. PICKENS. How would I describe it?

Mr. DORGAN. How would you compare yourself to IBM? Mesa and Boone Pickens, and IBM and its CEO? I know how the market describes it.

You're suggesting, somehow, that the market chooses all these victims and that the market creates the conditions; there are a lot of vagaries in the marketplace.

Mr. PICKENS. There's no doubt that IBM has done a tremendous job in long-range planning, and people that do a tremendous job in long-range planning will get short-term results. I mean, it just goes hand in hand. I mean for people to tell me, "Look, Pickens, you're a short-termer," and I'm a long-termer, that's ridiculous. If you're a long-termer, you're going to get short-term results also, and it will go just fine.

Now, IBM is in a totally different industry than we're in. We're in an industry where the industry has not replaced its reserves in the United States since 1972.

Mr. DORGAN. But those who appraise asset values or those who appraise companies in this country appraise the ability of that asset to return a dollar of income to its owner. And I'm just asking you if those who appraise IBM and ascribe value to IBM, and those who ascribe value to Mesa and you, are making such a substantial difference in appraisal——

Mr. PICKENS. They're not.

Mr. DORGAN. Yes, they are, according to the numbers.

Mr. PICKENS. No.

Mr. DORGAN. They're suggesting—at least, if you take a look at the appraised value of the assets of IBM versus the assets of Mesa——

Mr. PICKENS. What is the appraised value of——

Mr. DORGAN. Well, I don't have it here, but as I understand it, if you take a look at an array of appraisals of different companies, IBM, I believe—from information that I've seen which was given to the subcommittee—that it's around three times the appraised value of Mesa. Now, maybe we should clear that up, but that would suggest that someone believes that——

Mr. PICKENS. They're a lot more than three times the appraised value, Mesa——

Mr. DORGAN. Well, I talking about the market appraisal of a dollar of assets.

Mr. PICKENS. Now, wait a minute. Are you telling me that IBM is selling at a deep discount to appraised value? Or are they selling near appraised value, or selling over appraised value?

Mr. DORGAN. IBM is selling over appraised value, well over appraised value. You're selling at about appraised value. And I'm just asking if those who make those judgments are suggesting that your management is very inferior to IBM's. Are you suggesting that someone is able to make some kind of infallible judgment about management, or the vagaries of the market system or the appraisal basis here, based not just on management capability but on many, many other factors?

The reason I ask that question, Mr. Pickens, is that you have suggested that in every instance in which there is an appraised value that is less than what you think it ought to be, it's because of some slothful, indolent CEO someplace that's overpaid.

Mr. PICKENS. No. What I've said is that the market value is substantially below the appraised value, OK? And I'm talking about one industry, and that is the oil and gas industry. So when you take me outside and compare me to IBM, I would say the marketplace believes that IBM's future in their business endeavors are

probably more exciting than they are over in the oil and gas industry.

I'm also saying that oil and gas companies are depleting the reserves of their oil and gas and not replacing them in many instances, and the marketplace is reflecting that. That's why they sell at a deep discount, because they don't believe those managements are going to do anything for the stockholders before the primary asset is depleted.

Mr. DORGAN. And the assessment of the future, at least in part, is the assessment of the management. I understand that. It's true in the assessment of IBM's future, and it's true in the assessment of Mesa Petroleum's future.

Mr. PICKENS. That's right.

Mr. DORGAN. But it's not the whole assessment or the whole appraisal?

Mr. PICKENS. No.

Chairman PICKLE. Mr. Jones, would you care to ask some questions now?

Mr. JONES. Thank you, Mr. Pickle, for allowing me to sit in on the hearing even though I'm not a member of this particular subcommittee. As you know, I have a bill to deal with the greenmail problem and the use of junk bonds in hostile takeovers which has several cosponsors of this committee.

I have introduced my legislation not for the reasons you suggested in your testimony, Mr. Pickens, but I think there are some very serious public policy issues involved. One concern I have is the issue that you and others have brought about a highly leveraged corporate America. It makes the Federal Government, in terms of debt financing, look like pikers and Boy Scouts. I don't think that's good public policy.

Second, I think there is a tendency, particularly for those companies who feel they are going to be targets, to think in shorter and shorter terms as far as planning is concerned. I think one of the problems American management has now, at least in relation to Japanese and German management, for example, is that we are short-term planners. We are looking at the quarterly earnings report instead of looking at long-range planning. Moreover, I don't agree with you that long-range investment and planning should have only short-term payoff. I don't think you can prove that in every case.

Finally, I think this practice is soaking up a great deal of credit while the energy industry is finding no new energy. From what I can see, looking at Mesa Petroleum, most of the new oil that's been found by you has been found through the Wall Street operation and not through your own exploration activities.

Then what really disturbs me is that the Federal Government, through its Tax Code, is subsidizing these questionable practices.

So I would like to get into some questions, but before I do, I want to make sure I understood some of your answers to previous questions.

First of all, in response to Mr. Rangel, I think you said that no banker would loan money to you to buy Phillips Petroleum and, in essence, pledge the assets of Phillips for that kind of a loan. But if I'm not mistaken, it was Mesa Partners that you argued before the

FTC, who were the purchasers of Phillips. Mesa Partners, I don't believe, has any assets. And yet, you were able to arrange significant financing to buy Phillips. Presumably it would have to be secured by their assets. Is that right or wrong?

Mr. PICKENS. No, that's wrong.

Mr. JONES. All right. Who made the offer to buy Phillips?

Mr. PICKENS. We funded it through Mesa and Wagner and Brown, Mesa Partners. There were no Phillips assets pledged to anything, Mr. Jones.

Mr. JONES. So how did you go borrow the money?

Mr. PICKENS. We borrowed it on Mesa's assets, and then funded the partnership.

Mr. JONES. Well, I will go back and read the record, but it seems that is at odds with what your people argued before the FTC as to whether or not you should be subject to Hart-Rodino antitrust legislation. But I will go back and check the record on your findings with the FTC.

Also, I'm sure you didn't mean to say that you have never come to the Government for help. I believe you were here personally about 1 year ago when the question of whether to repeal section 311 with regard to distribution of appreciated property to shareholders came up. I believe you came to the Government and asked that that not be repealed, if I'm not mistaken.

Mr. PICKENS. I don't recall that.

Mr. JONES. Pardon?

Mr. PICKENS. I don't recall that.

Mr. JONES. That's the only other time I've met you.

On the Mesa situation, it's been brought out that you had $475 million in earnings in 1984, and you paid 1 percent of that in tax, but that you paid more tax in Canada than you did in the United States. Is that correct, or is that incorrect?

Mr. PICKENS. I'll have to answer that just like I did to Chairman Pickle, I don't recall. I know that we're operating within the tax laws of the United States.

Mr. JONES. I don't say it's illegal. I'm just saying, one of my concerns is a highly leveraged company such as yours that is so deeply in debt that you do not have the flexibility to do things, as was pointed out, in terms of what the limits are on what you can pay your stockholders——

Mr. PICKENS. We're going to have to challenge you on that one, Mr. Jones, about the highly leveraged nature of Mesa Petroleum. Do you know what our net debt is?

Mr. JONES. I can get that. Do you know? Go ahead and tell us.

Mr. PICKENS. Sure, I know what our net debt is.

Mr. JONES. All right.

Mr. PICKENS. It's slightly under $400 million. Do you know what our cash flow is?

Mr. JONES. Why do your bankers prohibit——

Mr. PICKENS. May I answer the——

Mr. JONES. Well, let me ask you a question first. You can answer it later.

Why do your bankers put a limitation on what you can pay in quarterly dividends and how much of the assets you can sell?

Mr. PICKENS. We told Mr. Anthony we would check that and come back to you and clarify the record on it. If you know——

Mr. JONES. No, I'm trying to find out. You seem to run the company, and I assume you have all this information——

Mr. PICKENS. Well, you're going to have certain—any time that you're borrowing money, you're going to have some restrictions by the bankers.

May I comment about our net debt?

Mr. JONES. Sure.

Mr. PICKENS. You're leaving the impression that the company is highly leveraged. We have slightly under $400 million in net debt, and the company's cash flow is over $200 million, about $250 million. So we could actually service our debt and completely clean it up in less than 2 years, which doesn't indicate to be highly leveraged.

Mr. JONES. I'm interested in your comments about management of other companies in the energy field. I am led to believe that last year, while I understand you were the highest paid executive in the country at $28 million in salary and bonuses, you were giving $13 million in dividends to your shareholders—that you have one of the lowest in the oil industry, 20 cents a year. Is that accurate or inaccurate?

Mr. PICKENS. No; it's inaccurate.

Mr. JONES. In what respect?

Mr. PICKENS. I was not given a $28 million bonus last year, to start with. I got a $3 million bonus——

Mr. JONES. I said salary and bonuses, $28 million.

Mr. PICKENS. No, it wasn't $28 million. I'll walk you through it if you would allow me to.

Mr. JONES. Well, I'd be happy to, because this figure is what we have; and if it's in error——

Mr. PICKENS. Well, let's get it corrected.

Mr. JONES. Go ahead.

Mr. PICKENS. OK. My bonus for a period of several years—I was given cumulative bonuses, $3 million in 1984. In 1985, there was a deferred compensation that was set up which was $20 million for—I was the major one in that group, which was $18 million of that $20 million to be paid out over a 5-year period. That $20 million also would work side by side with the Mesa stockholders and any future acquisitions that we did, and profits or losses would be charged against that $20 million. So in the Phillips deal, that particular pool, that deferred pool picked up $4 million. So you had $3 million, $20 million, and $4 million. I had $18 million of the $20 million. So had we lost on the pool, well, then the $20 million pool would have been charged for that in this situation.

Mr. JONES. Do you dispute——

Mr. PICKENS. Wait a minute. Let me please go forward if I could, because I want to make a very important point here, that if you go back to the Gulf deal, that Chevron and Gulf paid their investment bankers $64 million. Mesa Petroleum paid their investment bankers in that same transaction $8.5 million. In the Phillips deal, Phillips paid their investment bankers $35 million, and Mesa Petroleum paid their investment bankers zero. So when you add up the investment bankers for Chevron, Gulf, and Phillips in those two

transactions, it was $99 million. Mesa's investment bankers were paid $8.5 million.

The point I want to make is that we have in-house investment banking expertise, and that's exactly how these people were compensated. And by the way, when you compare my—the bonus pool that I was involved in, that is deferred, and any dividends were paid directly to the stockholders.

Mr. JONES. Do you dispute the fact that your dividends are among the lowest in the oil industry, 20 cents a year?

Mr. PICKENS. I don't dispute that, but I also take you back over periods of time when we compensate our stockholders in many ways. One is that we're selling at 100 percent of appraised value, which is great compensation for those stockholders, but second, we spinned off a royalty trust in 1979 to our stockholders, which was half of our gas reserve. And in 1982 we spinned off another royalty trust to our stockholders, so we may not have compensated in direct dollar distributions, but we certainly did in property value.

Mr. JONES. Mr. Chairman, I won't intrude on your time any longer but I appreciate your letting me sit in here.

Chairman PICKLE. Mr. Pickens, we do thank you. I've got two or three questions I want to ask, and we will submit to you other questions in writing and we'd like you to respond to us, as well as the other witness—that applies to you also, Mr. Andersen.

Mr. PICKENS. I'd be glad to do that.

[The information follows:]

MESA PETROLEUM CO.,
Amarillo, TX, April 26, 1985.

The Honorable J.J. PICKLE,
U.S. House of Representatives,
Washington, DC.

DEAR JAKE: It was a pleasure to appear before the House Oversight Subcommittee several weeks ago. At that time, I offered to send you information on Mesa's federal tax rate.

Mesa had loss carryforwards from oil and gas drilling efforts which were applied against its taxes through 1984. Consequently Mesa paid no taxes in 1984. However, in 1985, Mesa's tax rate is 46 percent. The company has already paid $10 million in the first quarter of 1985. We expect to pay $50 million for the year.

It is important to remember that the four deals in which Mesa has been involved have brought about $3.5 billion in taxes to the federal government.

You also had questions relating to the current price for Phillips Petroleum Company stock, which is selling around $40. The blended value of the stock is key, not what the stock is now selling for.

For instance, a Phillips shareholder owning ten shares of stock before Mesa's acquisition attempt, had stock valued at about $35 a share. As a result of Mesa's effort, the stock price rose to $62 a share, and let's say the owner was able to sell half his stock at that price because the stock was oversubscribed and had to be prorationed. His remaining stock is now selling for $40 a share. By averaging the $62 and $40, the shareowner has a blended value for his stock of about $51. So his shares have increased in value by about 16 points. Clearly, he is much better off as a result of Mesa's involvement.

Enclosed is an article by Michael Jensen from the Harvard Business Review. He summarizes the most important scientific evidence refuting the myths that surround takeover controversy. The research shows that (1) corporate takeovers do not waste resources, rather they use assets productively; (2) prohibition of plant closings, layoffs and dismissals following takeovers would reduce market efficiency and lower aggregate living standards, and (3) takeovers of companies by outsiders do not harm shareholders of the target company; in fact, they gain substantial wealth.

Please contact me if I can help you in any way.

Sincerely,

T. BOONE PICKENS, Jr.

Enclosures.

[From the Tulsa [OK] Tribune, Mar. 18, 1985]

THANKS FOR "TRUTH"

Editor, The Tribune:

Three cheers for you and Louis Rukeyser for printing and writing the truth behind T. Boone Pickens' "unpopularity" (March 8 Rukeyser column, "Pickens' crime: He dares to practice capitalism"). It's truly refreshing to see influencial publications and personalities speak out for true American principles. Keep up the good work. . .

KEN and PATI THURMAN.

[From the Harvard Business Review, November-December 1984]

TAKEOVERS: FOLKLORE AND SCIENCE

PUBLIC CRITICISM OF THE TAKEOVER MARKET IS LARGELY UNFOUNDED AND UNPRODUCTIVE

(By Michael C. Jensen)

[Criticism of the increasing number and complex collection of mergers, tender offers, leveraged buy outs, and proxy offerings has come from consumers, government, and business. The general negative reaction focuses on the amount of money involved and the complex managerial maneuvering among industrial giants.

[In the view of some financial economists, however corporate takeovers are the logical outgrowth of competitive struggles in the free market. If you accept the assumption that shareholders are the most important constituency of the modern corporation, then these mergers and acquisitions make sense because they increase the value of the shares held in the target company.

[Michael Jensen, one of the foremost proponents of this argument, has examined the various criticisms of corporate takeover activity and found many to be based on faulty logic. His conclusions are as controversial as the subject: takeovers are good for shareholders, golden parachutes are not unreasonable, mergers do not create monopoly power, takeovers serve a unique economic function. Whether you accept the underlying basis of his assertions, you will find them fascinating, for they bring the discussion out of the realm of prejudice. At the very least, they serve as a logical basis for realistic further investigation.

[Mr. Jensen is LaClare Professor of Finance and Business Administration at the Graduate School of Management, University of Rochester, founder and director of the Managerial Economics Research Center, and founding editor of the Journal of Financial Economics. During the academic year 1984–1985, he is visiting professor at the Harvard Business School. He is the author of numerous articles and editor of several books, including (with Clifford W. Smith, Jr.) The Modern Theory of Corporate Finance, (McGraw-Hill, 1984)]

From 1981 to 1983, the number of large U.S. corporate acquisitions grew at a rate roughly double that of the 1970s and even exceeded the one realized during the famous merger wave of the 1960s. The drama of 2,100 annual takeovers valued at more than $1 million—much of it played out in heated, public battles—has generated an enormous amount of criticism, not only from politicians and the media but also from high-level corporate executives.

Commenting in the *Wall Street Journal* on the Bendix and Martin Marietta takeover battle, for example, Lee Iacocca, chairman of Chrysler, argued: "It's not a merger. It's a three-ring circus. If they're really concerned about America, they'd stop it right now. It's no good for the economy. It wrecks it. If I were in the banking system I'd say no more [money] for conglomerates for one year."

A former director at Bendix added:

"I think . . . it's the kind of thing corporate America ought not to do, because the poor stockholder is the one whose interest is being ignored in favor of the egos of directors and executives. And who the hell is running the show—the business of making brakes and aerospace equipment—while all of this is going on?"

In a 1984 New York Times piece on the "surge of corporate mergers," Felix Rohatyn noted:

"All this frenzy may be good for investment bankers now, but it's not good for the country or investment bankers in the long run. We seem to be living in a 1920s, jazz age atmosphere."

Just as the public outcry over excesses on Wall Street in the early 1930s led to the Glass-Steagall Act regulating banking, so the latest criticisms of mergers have brought enormous political pressure to bear on Congress to restrict takeovers. The July 1983 report of the SEC Advisory Committee on Tender Offers contained 50 recommendations for new regulations. Democratic Representative Peter Rodino has cosponsored a bill that would require advance notice of proposed acquisitions resulting in assets of $5 billion and 25,000 employees and a judgment by the Antitrust Division of the Justice Department or the FTC whether such acquisitions "serve the public interest."

The popular view underlying these proposals is wrong, however, because it ignores the fundamental economic function that takeover activities serve. In the corporate takeover market, management teams compete for the right to control—that is, to manage—corporate resources. Viewed in this way, the market for control is an important part of the managerial labor market, which is very different from, and has higher stakes than, the normal labor market. After all, potential chief executive officers do not simply leave their applications with personnel officers. Their on-the-job performance is subject not only to the normal internal control mechanisms of their organizations but also to the scrutiny of the external market for control.

Imagine that you are the president of a large billion-dollar corporation. Suddenly, another management team threatens your job and prestige by trying to buy your company's stock. The whole world watches your performance. Putting yourself in this situation leads to a better understanding of the reasons behind the rhetoric, maneuverings, and even lobbying in the political and regulatory sectors by managers for protection from unfriendly offers.

The Bendix attempts to take control of Martin Marietta in 1982 gained considerable attention because of Marietta's unusual countertakeover offer for Bendix, called the "Pac-Man defense," whose principle is: "My company will eat yours before yours eats mine." Some describe this kind of contest as disgraceful. I find it fascinating because it makes clear that the crucial issue is not whether the two companies will merge but which managers will be in control.

At the end of the contest, Bendix held 67% of Martin Marietta while Martin Marietta held 50% of Bendix. United Technologies then entered as Martin Marietta's friend and offered to buy Bendix. But it was Allied, coming in late, that finally won the battle with its purchase of all of Bendix's stock, 39% of Martin Marietta's, and a promise not to buy more. When the dust had cleared, shareholders of Bendix and Martin had both won; their respective shares gained roughly 38% in value (after adjusting for marketwide stock price change). Allied's shareholders, on the other hand, lost approximately 8.6%.

Given the success and history of the modern corporation, it is surprising how little the media, the legal and political communities, and even business executives understand the reasons behind the complexities and subleties of takeover battles. Prior to the last decade, the academic community made little progress in redressing this lack of understanding. But research efforts in business schools across the country have recently begun to overcome it.

In this article I summarize the most important scientific evidence refuting the myths that swirl around the controversy. The research shows that:

Takeovers of companies by outsiders do not harm shareholders of the target company: in fact, they gain substantial wealth.

Corporate takeovers do not waste resources; they use assets productively.

Takeovers do not siphon commercial credit from its uses in funding new plant and equipment.

Takeovers do not create gains for shareholders through creation of monopoly power.

Prohibition of plant closings, layoffs, and dismissals following takeovers would reduce market efficiency and lower aggregate living standards.

Although managers are self-interested, the environment in which they operate gives them relatively little leeway to feature their nests at shareholders' expense. Corporate control-related actions of managers do not generally harm shareholders, but actions that eliminate actual or potential takeover bids are most suspect as exceptions to this rule.

Golden parachutes for top-level executives are in principle, in the interest of shareholders. Although the practice can be abused the evidence indicates that shareholders gain when golden parachutes are adopted.

In general the activities of takeover specialists benefit shareholders.

Before exploring the evidence, I consider why shareholders are the most important constituency of the modern corporation and why their interests must be held paramount when discussing the current wave of acquisitions and mergers.

THE NATURE OF THE CORPORATION

Stockholders are commonly portrayed as one group in a set of equal constituencies or "stakeholders," of the company. In fact, stockholders are not equal with these other groups because they are the ultimate holders of the rights to organization control and therefore must be the focal point for any discussion concerning it.

The public corporation is the nexus for a complex set of voluntary contracts among customers, workers, managers, and the suppliers of materials, capital, and risk bearing. The rights of the interacting parties are determined by law, the corporation's charter, and the implicit and explicit contracts with each individual.

Corporations, like all organizations, vest control rights in the constituency bearing the residual risk. (Residual risk is the risk associated with the difference between the random cash inflows and outflows of the organization.) In partnerships and privately held companies, for example, these residual claims and the organizational control rights are restricted to major decision agents (directors and managers); in mutuals and consumer cooperatives, to customers; and in supplier cooperatives, to suppliers.

Corporations are unique organizations because they make no restrictions on who can own their residual claims and this makes it possible for customers, managers, labor, and suppliers to avoid bearing any of the corporate residual risk. Because stockholders guarantee the contracts of all constituents, they bear the corporation's residual risk. The absence of restrictions on who can own corporate residual claims allows specialization in risk bearing by those investors who are most adept at the function. As a result, the corporation realizes great efficiencies in risk bearing that reduce costs substantially and allow it to meet market demand more efficiently than other organizations.

Although the identities of the bearers of residual risk may differ, all business organizations vest organizational control rights in them. For control to rest in any other group would be equivalent to allowing that group to "play poker" with someone else's money and would create inefficiencies that lead to the possibility of failure. Stockholders as the bearers of residual risk hold the right to control of the corporation, although they delegate much of this control to a board of directors who normally hire, fire, and set the compensation of at least the CEO.

Proof of the efficiency of the corporate organizational form shows dramatically in market performance. In principle, any marketer can supply goods and services. In reality, all organizational forms compete for consumers, managers, labor, and supplies of capital and other goods. Those that supply the goods demanded by customers at the lowest price win out. The dominance of the corporate form of organization in large-scale nonfinancial activities indicates that it is winning much of this competition.

ACQUISITION FOLKLORE

Takeovers can be carried out through mergers, tender offers, and proxy fights, or sometimes through elements of all three. A tender offer made directly to the stockholders to buy some or all of their shares for a specified price during a specified time period does not require the approval of the target company's management or board of directors. A merger, however, is negotiated with the company's management and, when approved by its board of directors, is submitted to the shareholders for approval. In a proxy contest the votes of the stockholders are solicited, generally for the election of a new slate of directors.

Takeovers frequently begin with what is called a "friendly" merger offer from the bidder to the target management and board. If management turns down the offer, the bidder can, and often does, take the offer directly to the shareholders in the form of a tender offer. At this point, target company managers usually oppose the offer by issuing press releases condemning it as outside the shareholders' best interest, by initiating court action, by requesting antitrust action against the bidder, by starting a countertakeover move for the bidder, and by other actions designed to make the target company a less desirable acquisition.

Target company management often casts about for a "white knight"–a friendly merger partner who will protect the "maiden" from the advances of the feared raider and, more important, who will pay a higher price. When the company doesn't find a white knight, and an unfriendly bidder takes it over, its leaders will likely look for new jobs. The takeover process penalizes incompetent or self-serving managers whose actions have lowered the market price of their corporation's stock. Although the process operates with a lag, the forces are strong and persistent. Of course–as a result of economies of scale or other efficiencies–some efficient managers lose their jobs after a takeover through no fault of their own.

This kind of romantic language has been used to offer comic relief, but it contributes to the atmosphere of folklore that surrounds a process fundamental to the corporate world. The resulting myths and misunderstandings distort the public's perception and render a meaningful dialogue impossible.

Folklore: Takeovers harm the shareholders of target companies.

Fact: The pejorative term *raider* used to label the bidding company in an unfriendly takeover suggests that the bidder will buy control of a company, pillage it, and leave the stockholders with only a crumbling shell.

Exhibit I.—Abnormal stock price increases from successful takeovers [1]

[In percent]

	Target companies	Bidding companies
Tender offers	30	4
Mergers	20	0
Proxy contests	8	[2] N.A.

[1] Adjusted to eliminate the effects of marketwide price changes
[2] Not applicable.

More than a dozen studies have painstakingly gathered evidence on the stock price effect of successful takeovers (see *Exhibit 1* for a summary of the results). According to these studies, companies involved in takeovers experience abnormal increases in their stock prices for approximately one month surrounding the initial announcement of the takeover. (Abnormal stock price changes are stock price changes customarily adjusted by regression analysis to eliminate the effects of marketwide forces on all corporations.) The exhibit shows that target company shareholders gain 30% from tender offers and 20% from mergers.

Because tender offers are often extended for less than 100% of the outstanding shares and because not all takeover announcements result in acquisitions, stock prices do not increase at the announcement of the offer by the full amount of the premium offered. Consequently, average target stockholder returns in takeovers are actually higher than the estimates in *Exhibit 1* because the abnormal stock price changes it summarizes generally exclude the purchase premiums shareholders receive when they surrender their shares.

The shareholders of bidding companies, on the other hand, earn only about 4% from tender offers and nothing from mergers. If the much feared raiding has taken place, it seems to be of a peculiar, Robin Hood variety.

When an insurgent group led by a dissatisfied manager or a large stockholder attempts to gain controlling seats on the board of directors of a company (thereby taking over the company through an internal proxy fight), shareholders also gain. As *Exhibit 1* shows, the stock prices of these companies gain 8% on average.

Because target companies are usually a lot smaller than the bidders, you cannot calculate total returns to both parties from the data in *Exhibit 1.* An analysis of more than 180 tender-offer acquisitions, however, indicates statistically significant gains to target and acquiring company shareholders equal to an average 8.4% of the total market value of the equity of both companies.

In sum, contrary to the argument that merger activity wastes resources without benefiting stockholders, stockholders earn substantial gains in successful takeovers. In the Texaco takeover of Getty, for example, Getty Oil shareholders realized abnormal stock price gains of $4.7 billion, or 78.6% of the total equity value, and Texaco shareholders, abnormal returns of $1.3 billion or 14.5%. Gains for both totaled $6 billion, 40% of the sum of their equity values. Gulf stockholders earned abnormal returns of $6.2 billion (79.9%) from the Social takeover, and Social stockholders earned $2.8 billion (22.6%). The total gains of $9 billion in this merger represent a 44.6% increase in the total equity values of both companies.

In light of these shareholder benefits, the cries to eliminate or restrain unfriendly takeovers seem peculiar (and in some cases self-serving). In a January 5, 1983 *Wall Street Journal* article. Peter Drucker called for such controls: "The question is no longer whether unfriendly takeovers will be curbed but only when and how." He went on to say:

"The recent shoot-out between Bendix and Martin Marietta has deeply disturbed even the staunchest laissez-faire advocates in the business community. And fear of the raider and his unfriendly takeover bid is increasingly distorting business judg-

ment and decisions. In company after company the first question is no longer: Is this decision best for the business? But, will it encourage or discourage the raider?"

Such arguments may comfort concerned managers and board members who want protection from the discipline of competition in the market for managers. But they are based on false premises. The best way to discourage the competing manager (that's what *raider* means) is to run a company to maximize its value. "Will this decision help us obtain maximum market value?" is the only logically sensible interpretation of "What is best for the business?"

Folklore: Takeover expenditures are wasted.

Fact: Purchase prices in corporate takeovers represent the transfer of wealth from the stockholders of bidding companies to those of target organizations, not the consumption of wealth. In a takeover, the resources represented in the cash received by the target shareholders can still be used to build new plant and equipment or for R&D.

The only resources consumed are those used to arrange the transaction, such as the time and fees of managers, lawyers, economists, and financial consultants. These expenses are often large in dollar terms; the financial fees of the U.S. Steel/Marathon Oil merger were more than $27 million, and those received by four investment banking firms in the Getty takeover hit a record by exceeding $47 million. But they are a tiny fraction of the dollar value of the acquisition; total financial and legal fees usually amount to only about .7%. More significantly, they help shareholders achieve their much larger gains of 4% to 30%.

In fact, the stock price change is the best measure of the takeover's future impact on the organization. The vast scientific evidence on the theory of efficient markets indicates that, in the absence of inside information, a security's market price represents the best available estimate of its true value. The evidence shows that market prices incorporate all current public information about future cash flows and the value of individual assets in an unbiased way. Stock prices change, of course, in response to new information about individual assets. Because market prices are efficient, however, the new information is equally likely to cause them to decrease or increase, after allowing for normal returns. Positive stock price changes, then, indicate a *rise* in the total profitability of the merged companies. Furthermore, because evidence indicates it does not come from the acquisition of market power, this increased profitability must come from the company's improved productivity.

Folklore: The huge bank credit lines used to carry out large takeovers siphon credit from the financial system and crowd out "legitimate" borrowing for productive investments.

Fact: First, the increases in shareholder wealth I've discussed indicate that takeover activities are productive investments; credit lines are not wasted. Second, companies that make acquisitions with stock or other securities, or with cash on hand or capital acquired from the sale of assets, do not use bank credit.

More important, even when companies accomplish takeovers with bank loans, they do not waste credit because most, if not all, of it is still available for real investment such as new plant and equipment. Let me illustrate the point by using a simple example.

When an acquiring company borrows from a bank for an acquisition, it receives the funds in the form of a credit to its bank account. When target company stockholders deposit receipts from the takeover in their accounts, the bank's total deposits remain unchanged because the acquirer's deposits are reduced by the same amount.

Now, however, the portfolios of the target company shareholders are unbalanced. In response, they can make new investments either directly or by purchasing newly issued shares, and if they do so the credit goes directly into productive real investments. If they take the opposite course of action and reduce their bank debt, the bank will have the same amount of loans and deposits as before the acquisition; total outstanding credit is unchanged and there is no waste.

Alternatively, target company shareholders can purchase securities from other investors, but the sellers then are in the same position as the target company shareholders after the acquisition.

If the recipients of the funds from the takeover don't make new investments or pay down debt, they must increase either their cash holdings or their consumption. If their wealth hasn't changed, they have no reason to change either their cash balances or their consumption, and, therefore, the proceeds will go to make new investments and/or reduce debt. If investor wealth increases, investors will increase their consumption and their cash balances. The value of the consumption and cash balance increases will only be a small fraction of the wealth increase (the capital gains, not the proceeds) from the takeover, the remainder will go for new investments

and/or debt reduction. The increase in cash balances and consumption will be the same as that coming from increases in wealth generated by any other cause. Thus, takeovers waste no more credit than any other productive investment.

Folklore: By merging competitors, takeovers create a monopoly that will raise product prices, produce less, and thereby harm consumers.

Fact: The evidence from four studies of the issue indicates that takeover gains come not from the merger's creation of monopoly market power but from its productive economies and synergy.

If the gains did come from the creation of companies with monopolistic powers, industry competitors would benefit, in turn, from the higher prices and would enjoy significant increases in profits and stock prices. Furthermore, the stock prices of rivals would fall if the FTC or the Antitrust Division of the Justice Department cancelled or challenged the merger.

The evidence indicates, however, that competitors gain when two other companies in the same industry merge. But these gains are not related to the creation of monopolistic power or industry concentration. Moreover, the stock prices of competitors do not fall on announcement of antitrust prosecution or cancellation of the acquisition. This evidence supports the hypothesis that takeover gains stem from real economies in production and distribution realized through the takeover and that it signals the availability of similar gains for rival companies.

In fact, the evidence raises serious doubts about the wisdom of FTC or Justice Department policies concerning mergers. The cancellation of an acquisition erases virtually all the stock price increases occurring on its announcement–with no apparent offsetting benefits to anyone.

Folklore: Consolidating facilities after a takeover leads to plant closings, layoffs, and employee dismissals–all at great social cost.

Fact: No evidence with which I am familiar indicates that takeovers produce more plant closings, layoffs, and dismissals than would otherwise have occurred.

This charge raises a serious question, however, about the proper criteria for evaluation of the social desirability of takeovers. The standard efficiency yardstick measures increases in the aggregate real standard of living. By these criteria the wealth gains from takeovers (and their associated effects) are good as long as they do not come from the creation of monopolistic market power. Therefore, even if takeovers lead to plant closings, layoffs, and dismissals, their prohibition or limitation would generate real social costs and reduce aggregate human welfare because of the loss of potential operating economies.

Some observers may not agree that the standard efficiency criterion is the best measure of social desirability. But the adoption of any other criterion threatens to paralyze innovation. For example, innovations that increase standards of living in the long run initially produce changes that reduce the welfare of some individuals, at least in the short run. The development of efficient truck and air transport harmed the railroads and their workers; the rise of television hurt the radio industry. New and more efficient production, distribution, or organizational technology often imposes similar short-term costs.

The adoption of new technologies following takeovers enhances the overall real standard of living but reduces the wealth of those individuals with large investments in older technologies. Not surprisingly, such individuals and companies, their unions, communities, and political representatives will lobby to limit or prohibit takeovers that might result in new technologies. When successful, such politics reduce the nation's standard of living and its standing in international competition.

Folklore: Managers act in their own interests and are in reality unanswerable to shareholders.

Fact: Because executive compensation is related to company size, critics charge that a top officer's desire for wealth and an empire drives merger activity while the stockholders pay the bill. But as *Exhibit 1* shows, there is no systematic evidence that bidding company managers are harming shareholders to build empires. Instead, the evidence is consistent with the synergy theory of takeovers. This theory argues that the stock price increases for target companies come from the increase in value obtained by consolidating or altering control of the assets of the companies involved, perhaps because of cost savings from economies of scale or from a highly complementary combination of employees and assets in production and distribution.

The evidence shows that target companies get a large share of the gains; indeed, the gains in mergers go to the target companies while virtually none accrue to bidding companies on the average. Bidding wars such as the DuPont-Seagram-Mobil competition for control of Conoco push up the gain for target companies.

The zero returns to bidders in mergers noted in *Exhibit I* are puzzling. For several reasons, however, this particular estimate has more uncertainty built into it and

is probably biased downward. My own assessment is that the returns to bidding companies in mergers are closer to the 4% shown for bidders in tender offers. An examination of the total dollar gains to both bidding and target company shareholders shows that both get about the same amount of dollars but not of percentage gains. The disparity results because bidding companies are generally larger than target companies and the same dollar gains translate into different percentage gains. Because the stock prices of larger companies vary more widely relative to gains in an acquisition than do the stock prices of target companies, their returns cannot be estimated as precisely.

Furthermore, bidders often engage in a prolonged acquisition program. The benefits for target companies from a particular merger occur around the time of the takeover announcement and therefore can be more easily estimated than the bidders' benefits, which may be spread out over several acquisitions.

Often the stock price of a company that seeks several acquisitions reflects the projected benefits of future deals at an early date. When a particular acquisition is announced, the bidder's stock price will change only to the extent that there is a difference between the actual and the previously expected profitability of the merger and on average this will be zero in an efficient market. And because mergers involve negotiations that do not occur in tender offers, more information about the intentions of bidders will leak than will information about the identity of the target; the effect on the bidder's price will therefore be spread out over time.

The record of several large takeovers shows mixed evidence on the returns to acquiring shareholders. In the $13.2 billion takeover of Gulf, Socal shareholders earned $2.77 billion (22.6%) after adjustment for the effects of marketwide price changes (from January 23, 1984 to May 3, 1984). Similarly, in the $10.1 billion takeover of Getty Oil, Texaco shareholders earned $1.3 billion (14.5%, from December 13, 1983 to February 7, 1984). In contrast, Allied shareholders lost $100 million (−8.6%) in the acquisition of Bendix; DuPont lost $800 million (−10.0%) in the takeover of Conoco, while Conoco shareholders realized a gain of 71%, or about $3.2 billion.

On the other hand, Occidental Petroleum shareholders did not lose in Occidental's takeover of Cities Service, whose shareholders gained about $350 million (12.5%). Mesa Petroleum initiated the Cities Service war with a bid of $45 per share. Cities Service countered with a bid for Mesa Petroleum. Gulf Oil then announced completion of negotiations to merge with Cities Service for $63 per share; Cities Service stock immediately gained over 43%, or $1.25 billion. In contrast, the Gulf stock price fell over 14%, or slightly over $900 million. The $350 million difference between the gain to Cities Service shareholders and the loss to Gulf shareholders measures the market's estimate of the net increase in value from the merger.

Citing antitrust difficulties with the FTC, Gulf cancelled its acquisition of Cities Service seven weeks later. Cities Service countered with a breach of contract suit against Gulf for $3 billion. All the earlier gains in the price of Cities Service stock were eliminated, but only one-third of the Gulf loss was recovered–perhaps because the market forecast that legal action might hold Gulf liable for part of the premium offered to Cities Service shareholders or that Gulf would make more overpriced takeover attempts. Within four weeks of the Gulf cancellation, Cities Service merged with Occidental for a $550 million premium–an amount identical to the estimated value of the net merger gains from the aborted combination of Cities Service and Gulf.

A good way for a company to become a takeover target is to make a series of acquisitions that reduce value but allow the value to be recovered through divestiture. A bidder that realizes it can make money by selling off the pieces at a profit will likely seize the initiative. Victor Posner's attack on Marley Company in 1981 is an extreme example. Marley, which manufactured water-cooling towers and heat exchangers, took control of Wylain, a manufacturer of air conditioning, heating, and pumping systems, for an 87% premium over Wylain's previous market value. Marley's stock price fell 21%. Posner bought 11.2% of Marley during the first six months of 1980. Unable to find a white knight, Marley sold its assets, dissolved and distributed the proceeds in June 1981. Posner received $21.9 million for his investment of $12.5 million in Marley.

MANAGER-SHAREHOLDER CONFLICTS

The interests of managers and shareholders conflict on many, but certainly not all, issues. The divergence intensifies if the company becomes the target of an unfriendly takeover. *Exhibit I* indicates that target shareholders benefit when the bidders offer substantial premiums over current market value. During a takeover top

managers of target companies can lose both their jobs and the value of their talents, knowledge, and income that are particular to the organization. Threatened with these losses, such officers may try to reduce the probability of a successful unfriendly takeover and benefit themselves at the expense of shareholders.

EXHIBIT II.—ABNORMAL STOCK PRICE CHANGES FROM UNSUCCESSFUL BIDS [1]

[In percent]

	Target companies	Bidding companies
Tender offers	−3%	−1
Mergers	−3	−5
Proxy contests	8	[2] N.A.

[1] Adjusted to eliminate the effects of marketwide price changes.
[2] Not applicable.

Management struggles

The attempt by Carter Hawley Hale to acquire Marshall Field is an interesting example of a management struggle to retain control. Marshall Field, a high-quality department and specialty store chain, enjoyed less growth than other retailers but consistently rejected merger bids. In early 1978, Carter Hawley Hale, another retailer, offered $42 per share for Marshall Field stock, which was selling for less than $20. Resisting, Marshall Field filed a lawsuit that argued the acquisition would violate securities and antitrust laws. It informed shareholders that the asking price was inadequate and made several defensive acquisitions that aggravated potential antitrust problems and made it less attractive to Carter Hawley. Marshall Field's board authorized top officials to take "such action as they deemed necessary" to defeat the offer. After Carter Hawley withdrew the offer, Marshall Field's stock fell back to $20 per share.

In April 1984, another retailer, The Limited, tried to take over Carter Hawley Hale, whose stock then experienced abnormal gains of 49% in the ensuing conflict. Carter Hawley filed suit against The Limited, claiming securities law violations and anti-trust proolems, and gave up 33% of its voting rights through the sale of $300 million of convertible preferred stock to General Cinema Corporation. Carter Hawley then gave General Cinema a six-month option to buy the Waldenbook chain, one of its most profitable subsidiaries, and repurchased 51% of its own shares. As a result The Limited withdrew its offer in Mary and Carter Hawley stockholders lost $363 million–the entire 49% abnormal stock price gain.

Both of these cases show what happens to stock prices when acquisition bids fail. *Exhibit II* summarizes the general evidence obtained from ten studies on stock price behavior during unsuccessful takeover attempts. The average abnormal stock price changes surrounding unsuccessful takeover bids are uniformly small and negative, ranging from −1% to −5%. The exception is the 8% positive return to shareholders of companies subjected to unsuccessful proxy contests. It is interesting that a proxy contest causes an abnormal stock price gain even when the challengers fail, perhaps because the contest threat motivates incumbent managers to change their strategies.

The uncertainty of the estimates, however, means that only the −5% return for unsuccessful bidders is statistically significantly different from zero. The other negative returns can arise by chance if the true returns from such unsuccessful offers are actually zero. In conclusion, the Marshall Field experience that target company shareholders essentially lose all the offered premiums when an acquisition bid fails, fits the general evidence.

Exhibit II, however, simplifies the story. Sometimes stockholders benefit greatly from opposition to takeover bids.

Uncoordinated, independent decisions by individual shareholders regarding the acceptance or rejection of a tender offer can cause most of the takeover gains to go to bidding company stockholders. If target managers act as the agents for all target shareholders in negotiating with the bidder for a higher price, however, this "free rider" problem can be alleviated.

Empirical evidence also indicates that some managerial opposition benefits target shareholders. For example, on the failure of a tender offer, target stock prices do not on average immediately lose the 30% average increase in price they earned when the offer was made. In fact, they generally stay up, apparently in anticipation

of future bids. And target companies that receive at least one more bid in the two years following the failure of a tender offer on average realize another 20% increase in price. Those targets that do not receive another bid, however, lose the entire initial price increase. Apparently, a little opposition in a merger battle is good, but too much can be disastrous if it prohibits takeover of the company.

The corporate charter

Corporate charters specify governance rules and establish conditions for mergers, such as the percentage of stockholders who must approve a takeover. Since constraints on permissible charter rules differ from state to state, changing the state of incorporation will affect the contractual arrangement among shareholders and the probability that a company will be a takeover target. It is alleged that some states desiring to increase their corporate charter revenues make their statutes appealing to corporate management. Allegedly, in doing so they provide management with great freedom from stockholder control and therefore provide little shareholder protection. Delaware, for example, has few constraints in its rules on corporate charters and hence provides much contractual freedom for shareholders. William L. Cary, former chairman of the Securities and Exchange Commission, has criticized Delaware and argued that the state is leading a "movement towards the least common denominator" and "winning a race for the bottom."

But a study of 140 companies switching their state of incorporation reveals no evidence of stock price declines at the time of the change, even though most switched to Delaware. In fact, small abnormal price increases are usually associated with the switch. This evidence is inconsistent with the notion that such charter changes lead to managerial exploitation of shareholders.

Without switching their state of incorporation, companies can amend corporate charters to toughen the conditions for the approval by shareholders of mergers. Such antitakeover amendments may require a "super majority" for approval or for the staggered election of board members and can thus lower the probability that the company will be taken over and thereby reduce shareholder wealth. On the other hand, the amendments can also benefit shareholders by increasing the plurality required for takeover approval and thus enable management to better represent their common interests in the merger negotiations.

Two studies of adoption of antitakeover amendments in samples of 100 and 388 companies reveal no negative impact on shareholder wealth. One exception may arise if the super-majority provisions grant effective power to block mergers to a manager-stockholder. The market value of R. P. Scherer, for example, fell 33.8% when shareholders adopted an 80% super-majority merger approval provision. Because the wife of Scherer's CEO owned 21.1% of the stock, she then had the power to block a proposed takeover by FMC. In fact, FMC withdrew its offer after Scherer stockholders approved the 80% majority provision and the price of Scherer stock plummeted.

Repurchase standstill agreements

Currently available evidence suggests that management's opposition to takeovers reduces shareholder wealth only when it eliminates potential takeover bids. In a privately negotiated or targeted repurchase, for example, a company buys a block of its common stock from a holder at a premium over market price–often to induce the holder, usually an active or a potential bidder, to cease takeover activity. Such repurchases, pejoratively labeled "greenmail" in the press, generate statistically significant abnormal stock price declines for shareholders of the repurchasing company and significantly positive returns for the sellers. These stock price declines contrast sharply with the statistically significant abnormal stock price increases associated with nontargeted stock repurchases found in six studies.

The managers of target companies also may obtain standstill agreements, in which one company agrees to limit its holdings in another. Announcements of such agreements are associated with statistically significant abnormal stock price declines for target companies. Because these agreements almost always lead to the termination of an acquisition attempt, the negative returns seem to represent the merger gains lost by shareholders.

Again, however, the issue is not clearcut because closer examination of the evidence indicates that these takeover forays by competing managers benefit target shareholders. Within ten days of an acquisition of 5% or more of a company's shares, the SEC requires the filing of information giving the identity of the purchaser, purpose of acquisition, and size of the holding. The significantly positive increase in stock price that occurs with the initial pruchase announcement indicates that potential dissident activity is expected to benefit shareholders even given the chance that the venture will end in a targeted repurchase. Moreover, this is confirmed by

the fact that on average during the period from the SEC filing through the targeted repurchase of the shares, target company shareholders earn statistically significant positive abnormal returns.

Thus, when you look at the whole process, repurchase agreements are clearly not "raiding" or "looting" but are profitable for the target shareholders–although not as profitable as a takeover. The stock price decline at repurchase seems due to the repurchase premium that is effectively paid by the nonselling shareholders of the target firm and to the unraveling of takeover expectations with consequent loss of the anticipated takeover premium.

Because, on average, target shareholders lose the anticipated takeover premiums shown in *Exhibit I* when a merger or takeover fails for any reason, we cannot easily tell whether they were hurt by a repurchase. If the takeover would have failed anyway and if the target company's stock price would have fallen even more without the repurchase, then the repurchase benefited target company shareholders. Such additional price declines might be caused, for example, by the costs of dealing with a disgruntled minority shareholder.

Although the issue requires further study, current evidence implies that prohibition of targeted-large-block repurchases advocated by some may hurt target shareholders. Moreover, since shareholders can amend corporate charters to restrict targeted repurchases, there is little justification for regulatory interference by the state in the private contractual arrangements among shareholders. Such repurchase restrictions might well restrict the vast majority of stock repurchases that clearly benefit shareholders. In addition, by reducing the profitability of failed takeovers, such restrictions would strengthen the position of entrenched managers by reducing the frequency of takeover bids. Doing so would deprive shareholders of some of the stock price premiums associated with successful mergers.

Going private

The phrase *going private* means that publicly owned stock is replaced with full equity ownership by an incumbent management group and that the stock is delisted. On occasion, when going private is a leveraged buy out, management shares the equity with private investors. Some believe that incumbent managers as buyers are exploiting outside shareholders as sellers in these minority freezeouts.

Advocating restrictions on going-private transactions, in 1974 Securities and Exchange Commissioner A A. Sommer, Jr. argued:

"What is happening is, in my estimation, serious, unfair, and sometimes disgraceful, a perversion of the whole process of public financing, and a course that inevitably is going to make the individual shareholder even more hostile to American corporate mores and the securities markets than he already is."

Study of stockholder returns in 72 going-private transactions, however, reveals that the average transaction offers a premium 56% over market price and that abnormal stock price increases on announcement of the offer average 30%. The gains apparently arise from savings of registration and other public ownership expenses, improved incentives for decision makers under private ownership, and increased interest and depreciation tax shields. Outside shareholders are not harmed in going-private transactions.

Golden parachutes

Some companies provide compensation in employment contracts for top-level managers in the event that a takeover occurs—that is, golden parachutes. Allied agreed, for example, to make up the difference for five years between Bendix CEO William Agee's salary in subsequent employment and his former annual $825,000 salary in the event of a change in control at Bendix. Much confusion exists about the propriety and desirability of golden parachutes, even among senior executives.

But the detractors fail to understand that the parachutes protect stockholders as well as managers. Think about the problem in the following way: top-level managers and the board of directors act as stockholders' agents in deals involving hundreds of millions of dollars. If the alternative providing the highest value to stockholders is sale to another company and the retirement of the current management team, stockholders do not want the managers to block a bid in fear of losing their own jobs. Stockholders may be asking managers to sacrifice position and wealth to negotiate the best deal for them.

Golden parachutes are clearly desirable when they protect stockholders' interests. Like anything else, however, they may be abused. For example, a stockholder doesn't want to pay managers so much for selling the company that they hurry to sell at a low price to the first bidder. But that is a problem with the details of the parachute's contractual provisions and not with the existence of the parachute itself. An analysis of 90 companies shows that adoption of golden parachutes on av-

erage has no negative effect on stock prices and provides some evidence of positive effects.

The thing that puzzles me about most golden parachute contracts is that they pay off only when the manager leaves his job and thus create an unnecessary conflict of interest between shareholders and executives. Current shareholders and the acquiring company will want to retain the services of a manager who has valuable knowledge and skills. But the officer can collect the golden parachute premium only by leaving; the contract rewards him or her for taking an action that may well hurt the business. As the bidder assimilates the knowledge that turnover among valuable top-level managers after the acquisition is highly likely, it will reduce its takeover bid. A company can eliminate this problem by making the award conditional on transfer of control and not on the manager's exit from the company.

Selling the 'crown jewels'

Another often criticized defensive tactic is the sale of a major division by a company faced with a takeover threat. Some observers claim that such sales prove that managers will do anything to preserve their tenure, even to the extent of crippling or eliminating major parts of the business that appear attractive to outside bidders. Such actions have been labeled a "scorched earth policy."

Studies of the effects of corporate spin-offs, however, indicate they generate significantly positive abnormal returns. Moreover, when target managers find a white knight to pay more for the entire company than the initial, hostile bidder, shareholders clearly benefit.

In the same way, when an acquirer is interested mainly in a division rather than the whole company, shareholders benefit when target management auctions off the unit at a higher price. Brunswick's sale of its Sherwood Medical Industries division to American Home Products shows how the sale of a crown jewel can benefit shareholders. Whittaker Corporation made a hostile takeover bid for Brunswick in early 1982. In defense, Brunswick sold a key division, Sherwood Medical, to American Home Products through a negotiated tender offer for 64% of Brunswick's shares. American Home Products then exchanged these shares with Brunswick for Sherwood's stock. Because its main interest lay in acquiring Sherwood, Whittaker withdrew its offer.

The value of the Whittaker offer to Brunswick shareholders ranged from $605 million to $618 million, depending on the value assigned to the convertible debentures that were part of the offer. The total value to Brunswick shreholders of the management strategy, selling off the Sherwood division, was $620 million. Moreover, because of the structure of the transaction, the cash proceeds went directly to the Brunswick shareholders through the negotiated tender offer. The $620 million value represents a gain of $205 million (49%) on the total equity value of Brunswick prior to the initial Whittaker offer. The Brunswick shareholders were $2 million to $15 million better off with the management strategy, hardly evidence of a scorched-earth policy.

Takeover artists

Recently, criticism has been directed at corporate takeover specialists who are said to take advantage of a company's vulnerability in the market and thus ultimately harm shareholders. While acting in their own interests, however, these specialists also act as agents for shareholders of companies with entrenched managers. Returning to the Marshall Field story, for example, Carl Icahn launched a systematic campaign to acquire the chain after it had avoided takeover. When it looked as if he would achieve the goal, Marshall Field initiated a corporate auction and merged with BATUS (British American Tobacco Company, U.S.) for $30 per share in 1982. After adjustment for inflation, that price was slightly less than the $20 price of Field's stock in 1977, when it defeated Carter Hawley's $42 offer.

Takeover specialists like Icahn risk their own fortunes to dislodge current managers and reap part of the value increases available from redeploying the assets or improving the management. Evidence from a study of 100 such instances indicates that when such specialists announce the purchase of 5% or more of a company's shares, the stockholders of that company on average earn significantly positive abnormal returns of about 6%.

THE EFFECTIVENESS OF THE MARKET

The corporation has contributed much to the enhancement of society's living standards. Yet the details of how and why this complex institution functions and survives are poorly understood, due in part to the complexity of the issues involved and in part to the political controversy that historically surrounds it. Much of this

controversy reflects the actions of individuals and groups that wish to use the corporation's assets for their own purposes, without purchasing them.

One source of the controversy comes from the separation between managers and shareholders–a separation necessary to realize the large efficiencies in risk bearing that are the corporation's comparative advantage. The process by which internal control mechanisms work so that professional managers act in the shareholders' interest is subtle and difficult to observe. When internal control mechanisms are working well, the board of directors will replace top-level managers whose talents are no longer the best ones available for the job.

When these mechanisms break down, however, stockholders receive some protection from the takeover market, where alternative management teams compete for the rights to manage the corporation's assets. This competition can take the form of mergers, tender offers, or proxy fights. Other organizational forms such as nonprofits, partnerships, or mutual insurance companies and savings banks do not benefit from the same kind of external market.

The takeover market also provides a unique, powerful, and impersonal mechanism to accomplish the major restructuring and redeployment of assets continually required by changes in technology and consumer preferences. Recent changes occurring in the oil industry provide a good example.

Scientific evidence indicates that activities in the market for corporate control almost uniformly increase efficiency and shareholders' wealth. Yet there is an almost continuous flow of unfavorable publicity and calls for regulation and restriction of unfriendly takeovers. Many of these appeals arise from managers who want protection from competition for their jobs and others who desire more controls on corporations. The result, in the long run, may be a further weakening of the corporation as an organizational form and a reduction in human welfare.

Chairman PICKLE. I regret in a way, Mr. Andersen, we haven't paid you proper respect here today. We might want to have you back again. I want to ask you a couple of questions in the meantime.

But let me ask Mr. Pickens this question. When you accepted the offers made for your stock in, say, the last four recent takeovers, did you verbally promise the management or did you sign any kind of agreement that you'd do certain things, not to buy any more stock or not to try to take over the company?

Mr. PICKENS. Yes, sir, I did.

Chairman PICKLE. Well, if you did that, how can you be helping the stockholders by saying, "I promise not to take you over," or "I won't do anything for you." How do you figure that that's a gain for the stockholders when you're supposed to be helping the stockholders?

Mr. PICKENS. Oh, I can explain that very well, sir. Would you like for me to go back through each one of the transactions?

Chairman PICKLE. Well——

Mr. PICKENS. I can do it in 2 minutes.

Chairman PICKLE. Well, you can answer it in general.

Mr. PICKENS. Well, in the Cities Service deal that Gulf came in and topped our $50 offer with $63, and the Cities Service management came to us and said, "We want you out; we don't want to fool with you any more, now leave and we'll give you $55 to leave." Now, there's an offer on the table for $63 at this point, so we went out at $8 under, and we did leave. I mean, the stockholders were helped tremendously. Cities Service was——

Chairman PICKLE. You were helping the stockholders by not doing anything to them?

Mr. PICKENS. No, that's not right. What we did, at this point, is that our offer has been topped. Cities Service was a $20 stock when we made the $50 offer. So we were topped at $63, and they said,

"You'll have to leave. We'll pay you off to leave, and here, you've got to give us some other"——

Chairman PICKLE. And they paid you off, and that's not greenmail?

Mr. PICKENS. No, sir, that's not greenmail because the offer was over what we got for the stock. Had we gotten a premium to what the other stockholders had, it would have been greenmail.

Chairman PICKLE. It would seem to me that you're having a different kind of definition of greenmail than a lot of other people have. Let me see if I could reconstruct—I'm just trying to recall this, and I may not—but you said you didn't get any greenmail?

Mr. PICKENS. No, sir.

Chairman PICKLE. All you got was that which was offered to all of the stockholders.

Mr. PICKENS. We actually gave up something the other stockholders didn't give up, because we gave up a standstill agreement. None of the rest of them had to give up a standstill agreement.

Chairman PICKLE. Well, when you say that you had never received any greenmail, I'm asking you, are the public shareholders of Phillips getting the same amount, the same kind of deal that you did?

Mr. PICKENS. Yes.

Chairman PICKLE. Well, now, you got $53 cash per share, and the stockholders, the majority of them, got that much, a little more—long-term, with interest?

Mr. PICKENS. No, sir; there was——

Chairman PICKLE. With interest, that's all?

Mr. PICKENS. There was a market for those securities. And as Mr. Douce said, the value of those securities on the day that the deal was made was $56 to $57. You could sell them right then. You're not talking about a long-term deal. If you wanted to hold them, you could sell them——

Chairman PICKLE. But if that company gets in difficulty, of course, they'd lose their shirts then——

Mr. PICKENS. No, no, no.

Chairman PICKLE [continuing]. Because the stock had been built up?

Mr. PICKENS. No; let me correct you on that. At the time that the deal is made, the stockholders of Phillips Petroleum could sell their stock and the combination of those securities by Mr. Douce was worth $56 to $57, right there, that day.

Chairman PICKLE. Well, it couldn't have been that day. But I look at the stock market now and I see that Phillips is worth about $38 on the market now.

Mr. PICKENS. Well, see, they've reduced their capitalization, and they've brought half their stock back in for $62. So you add $62 to the $38 plus the preferred stock in the deal, which gets you up pretty close to $55.

Chairman PICKLE. If you go to buy stock in the market——

Mr. PICKENS. If you divide by 2. You have to divide by 2.

Chairman PICKLE. I don't understand the market that well, but I do know when you open up the financial section in the morning and you look at it and you see Phillips is worth 38½—and yet you were paid, in the process of building up, $52 or $53 a share.

Mr. PICKENS. Mr. Pickle, let me take you back. Since it's 38, they have already bought back half the stock back in from the stockholders at $62. So you actually take the $62 purchased for half the stock, add it to the $38, and that then is divided by 2, which will get you 100, divided by 2, is 50. Then they get another $4 on the preferred stock, which will be $54-something for that. So they bought back half their stock at $62. That's to all the stockholders.

Chairman PICKLE. It just seems to me, Mr. Pickens, that you start off with a company whose stock is valued low; and because it is low, because you and your people make studies and ascertain that that stock—that that company's really worth more than that, and you bid it up, and you increase that stock—as you did in Phillips—$10 to $15, and when you see you can't get control, or you reach that conclusion, you sell out. They say, "We don't want to see you around any more. We'll pay you off."

Now, you don't call that greenmail?

Chairman PICKLE. No, sir, because we negotiated a deal with the Phillips management that all the stockholders would get the same thing.

Chairman PICKLE. And that is not——

Mr. PICKENS. That is not greenmail. Had they paid us like Texaco paid the Basses, paid them $50—the stock price went to $35—then that is greenmail. But in this case, the other stockholders got the same thing we did.

Chairman PICKLE. Well, it's obvious I've got to learn more about greenmail, and I'll do some more studying on it.

Mr. PICKENS. Mr. Pickle, let me tell you, you ought to love us because the price of Phillips was $37 and the price that it eventually worked out to was at $53 or $54, and maybe even higher. Well, there's about 15 or 20 points in here on 155,000 shares of stock. You're talking about $3 billion worth of profits, Mr. Pickle.

Chairman PICKLE. I noticed that you said that in your statement, that Uncle Sam would make $3 billion, and I don't understand just how that worked out. You're assuming that if they sold it——

Mr. PICKENS. They didn't make $3 billion off of Phillips; that was all the deals put together. It just so happens that there are two $3 billion figures here. But Phillips stockholders were enhanced by $3 billion because of our presence in that company.

Chairman PICKLE. Well, that means if they sold, but you don't know if they did and you don't know that we got any taxes from it?

Mr. PICKENS. Sure, they had to have, because half of the stock came in at $62. So it's there, the value is there.

Chairman PICKLE. Well, let me ask you——

Mr. JONES. Would the chairman yield on that?

Chairman PICKLE. I'll yield.

Mr. JONES. In driving up the stock, how much interest deductions were taken away from the revenues that the Government would get? Isn't it about $600 million? Wouldn't that wipe out all of the revenues that you said we would get?

Mr. PICKENS. Well, remember, Mr. Jones, that we were paying interest to the banks and they were paying you taxes on that interest.

Mr. JONES. I'm talking about Icahn and you combined.

Mr. PICKENS. I don't know what Mr. Icahn had. I'm just saying that whatever we borrowed——

Mr. JONES. If you can show us where the Government benefited from that, I'd like to see it. I don't——

Mr. PICKENS. Oh, there's no problem at all to show you where they benefited from it because of—just multiply the enhancement in the marketplace on the Phillips——

Mr. JONES. With no offsets?

Mr. PICKENS. Oh, the offsets will be insignificant.

Mr. JONES. I'd like to see your math.

Mr. PICKENS. Sure. Be glad to.

Mr. JONES. You ought to be the Budget Director here.

Mr. PICKENS. Well, I think I could handle it.

Chairman PICKLE. We must move on to the next panel.

Mr. FLIPPO. Mr. Chairman, there is one very important point, I think, that we need to get on the record from Mr. Andersen in regard to junk bonds—if I might just ask one question about that?

Chairman PICKLE. All right.

Mr. FLIPPO. Mr. Andersen, I believe that Mr. Pickens has testified that the funds that they borrowed were based upon the assets of Mesa. What are the assets securing junk bonds? Are they the assets of the target corporation, or what are the assets underlying and securing junk bonds?

Mr. ANDERSEN. In the instance of any company that is obtaining credit, they are obtaining credit basically on their balance sheet.

Mr. FLIPPO. Are you saying—if I understand you correctly, and let me make sure I understand what you're saying—you're saying that the security for junk bonds is not the assets of the target corporation?

Mr. ANDERSEN. I am saying that——

Mr. FLIPPO. Or the merged corporation?

Mr. ANDERSEN. I am saying that it is the assets of the borrowing corporation. The other way of looking at it, is to look at it like buying a house. And you would not say to someone who is buying a house, "First buy the house and then come talk to me about a mortgage." What you would say is, "I will give you a mortgage if you acquire the house. The mortgage is on your credit. If you secure the house, you can draw down the mortgage."

Mr. FLIPPO. Well, I won't pursue it, Mr. Chairman, but I wonder—in the final analysis, is it reasonable to expect that the assets of the target corporation are the security for the junk bonds? I'm not talking legalistically or any other way, just——

Mr. ANDERSEN. There is no difference in the assets secured in the acquisition of a company if they use single B or double B rated debt than there is in the same claim on assets that was taken on by Chevron when they acquired control of their acquisitions or anybody else. It's the same, basic, fundamental economics, that the company must be sound, must demonstrate the cash flow capabilities to secure the debt.

Mr. FLIPPO. Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Andersen, are these so-called junk bonds risky?

Mr. ANDERSEN. I think if you go back to the turn of the century and look at the research that has been done from that date for-

ward, primarily by the National Bureau of Economic Research, you will find that the rate of return paid on junk bonds more than compensate for the risk assumed, that is, the incremental rate of return. That is the reason this market has grown. This risk is manageable for those who invest in diversified portfolios of these securities.

Chairman PICKLE. Well, is that why they pay a higher rate of interest than the other bonds?

Mr. ANDERSEN. They absolutely pay a higher rate of interest than the other bonds, and the reason is that the market place has incorrectly evaluated, historically, the risk versus the reward.

Chairman PICKLE. Not the risk, just that the reward is greater?

Mr. ANDERSEN. If you look at triple A bonds, they pay more than U.S. Government bonds. If you look at double A bonds, they pay more than triple A bonds. And so on, right straight down the spectrum. It is the definition of how the investor perceives the incremental risk for the incremental amount of interest that they charge.

Chairman PICKLE. I wish that we could ask a lot of other questions, but we must submit them to you in writing.

We thank both of you for coming. I want to assure you that we're not trying to impute any kind of ill motive; I'm sure that what you've done is properly within the law, but we're trying to see how it affects our Treasury.

Did you want to say something else?

Mr. PICKENS. I wanted to make just one clarification for Mr. Jones. I think you said I visited you about—that I came to you for help. I don't believe I did come to you, but one of our people here says that he did come to you, and it was about changing the law relating to taxing appreciated assets, which was the royalty trust concept at that time. And we didn't ask you for help on it; what we asked you to do was just leave it alone where it was, don't change it. [Laughter.]

So we weren't up here trying to get laws passed; we were just saying that——

Mr. JONES. You were trying to prevent a correctional law, and that is not my recognition of——

Mr. PICKENS. We didn't identify that as asking Government for help. We were just saying "leave it alone."

Chairman PICKLE. Mr. Pickens, I don't remember it exactly that way. I thought you were trying to set up a royalty trust and set up units that would have some value——

Mr. PICKENS. Absolutely, Mr. Chairman.

Chairman PICKLE [continuing]. And your company did come to me, and I thought it was probably a pretty good idea. But when the committee decided to tax them, you dropped it like a hot potato.

Mr. PICKENS. No, we didn't drop it like a hot potato; it was over with, as it happened. It was the only thing in the Tax Reform Act of 1984 that lost revenues for the Government, so we said, "Leave it in."

Chairman PICKLE. I don't know that I was in disagreement with you on it, but you were here asking for some Government assistance to carve that out.

Mr. PICKENS. We just said, "Leave us alone," is all we were saying.

Chairman PICKLE. Well, thank you both very much.

The Chair will have to call for another 10-minute recess. I'm going to ask the next panel, Mr. Fred Hartley, chairman and president of Union Oil of California, and Mr. William Douce, chairman of the board and chief executive officer of the Phillips Petroleum Co.

And Mr. Pickens, you and Mr. Andersen would be welcome to stay and listen to these two gentlemen, if you would like.

[Recess taken.]

[Letters and responses follow:]

COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC, May 21, 1985.

Mr. T. BOONE PICKENS, Jr.,
President and Chairman, Mesa Petroleum Co.
Amarillo, TX.

DEAR MR. PICKENS: Thank you for appearing as a witness at the Subcommittee's hearing on mergers and acquisitions. Your experience and expertise provided the Subcommittee with much valuable analysis and information. For the purpose of completing the Subcommittee's hearing record, I have enclosed a series of additional questions for your response.

I would appreciate your review and response to my office by June 3, 1985. If you have any questions, please contact Bill Cunningham of the Subcommittee staff at 225-5522.

Sincerely yours,

J. J. PICKLE, *Chairman, Subcommittee on Oversight.*

Enclosures.

1. Time magazine, March 4, 1985, reports that you made the following pre-tax gains from mergers you were involved in:

[In millions of dollars]

1982: Supron	22.3
1982: Cities Service	31.5
1982–83: General American Oil	43.6
1983: Superior Oil	31.6
1984: Gulf	760
1985: Phillips	89 (?)

(a) Is this correct?

(b) Will you or did you pay tax on this profit at capital gains rates or ordinary income rates? If capital gains rate, how could this occur since the holding period is currently 6 months?

2. Last year, you forced Gulf, the fifth largest U.S. oil company to sell out to the fourth largest U.S. oil company for $13.2 billion. This was the biggest merger in business history.

(a) Is this correct?

(b) Why was Gulf an attractive merger target?

(c) Did the tax laws affect your decision to acquire Gulf or affect how the deal was structured?

3. Reports indicate that you raised $1.3 billion in credit from bankers and partners in your 6-month battle with Gulf Oil, and $1.2 billion in credit for acquisition of stock in Unocal.

(a) How long does it take you to line up this borrowing power?

(b) Who are the financiers?

4. (a) To what extent have "junk bonds" been used in merger transactions in which you have been involved?

(b) Is the deductibility of debt integral to your decision to borrow funds to finance the acquisitions?

5. According to John S. Herold, Inc., an appraiser of oil companies, shares of major energy firms are currently trading at about 45 percent of what the corporations would be worth if they were broken up and their assets sold separately.

(a) Is this a major reason why you select certain firms for acquisition?

(b) What other industry groups are vulnerable as targets because their stocks trade at prices below the value of the firms' assets?

6. What are the assets of Mesa Partners II? Are the assets of Mesa Petroleum "at risk" in Mesa Partners II when junk bonds are issued on behalf of Mesa Partners II?

7. Have you or do you intend to take a tax deduction for commitment fees paid in connection with junk bonds?

8. During your testimony you agreed to provide information on the limitations your bankers have imposed on quarterly dividends and asset sales. Please prove the details.

9. During your testimony you agreed to provide detailed facts to support your statement that your acquisition efforts have increased U.S. tax receipts by over $3.5 billion. Your letter of April 26, 1985 again makes this assertion. However, there is no explanation of how you arrived at this figure. Please provide this information to us.

MESA PETROLEUM CO.,
Amarillo, TX, June 7, 1985.

Hon. J. J. PICKLE,
U.S. House of Representatives,
Washington DC.

DEAR JAKE: Thank you for your letter. You've asked some very good questions. This letter answers them by number and section without restating the question.

1. (a) Your chart is correct with two exceptions, the pre-tax gains from Gulf were $404 million, and from Phillips were $75 million. As I mentioned in my April 26, 1985 letter, Mesa had tax loss carryforwards from oil and gas drilling efforts which were applied against its taxes through 1984.

(b) Of the six transactions, Superior and Phillips are treated as short term capital gains. The other four are treated as long term capital gains because they were held more than one year.

2. (a) It is incorrect to state that Mesa "forced" Gulf to sell out to Chevron. Gulf made that decision. Mesa offered Gulf the opportunity to create a royalty trust, which would have created taxes for the government and values for shareholders. Gulf resisted and Mesa made a tender offer to increase its ownership. At that point Chevron entered the picture.

(b) The value of Gulf's assets was substantially in excess of the value of its stock. Management was not performing and shareholders were not realizing the value of their investment. Gulf was in liquidation because it had been unable to replace its reserves for 12 straight years. Shareholders were ready to see value created to stem the trend of steady dilution of their stock.

(c) As you know, tax laws affect every economic decision made in business. The interest deduction affects all purchasers of assets be they hostile or friendly. It is important to remember that interest deductions are balanced by tax on interest income.

3. (a) Mesa maintains an oil and gas base line of credit on an ongoing basis. It requires one to two weeks to line up a margin credit.

(b) First and foremost Mesa arranges financing based on its oil and gas assets. So, banks are in a secure, collateralized position. Mesa has also arranged margin credit which is secured by stock in accordance with the margin regulations of the Federal Reserve. All of these funds are provided by banks.

4. (a) The only transaction in which Mesa arranged financing using subordinated securities was in its offer for Unocal. The securities consisted of senior notes and preferred stocks. It is important to note that the securities were to be purchased by very sophisticated financial buyers, who had conducted careful analysis. The securities were never issued. I call your attention to the attached Wall Street Journal editorial published on May 31, in which Frederick Joseph notes that "of the $122 billion used to finance mergers and acquisitions in 1984, less than 2% came from high yield bonds. Most of these activities were financed by cash, bank borrowing or internally generated cash flow. Commitments to fund attempted takeovers with high-yield bonds have been greater this year, but have actually been exercised only in the highly regarded hostile-turned-friendly acquisition of American Natural Resources by Coastal Corp." On the question of default ratios, Mr. Joseph points out that "because of the hostile environment and the speed with which such financings must be arranged, these issues have been of higher credit quality than other issues providing comparable returns. They have been carefully structured to provide significant protection to the institutional purchasers."

(b) I presume you mean the deductibility of interest. The only reason anyone is willing to buy an asset is because his analysis shows he can earn a return in excess of the assets' cost, including interest costs. When profits are earned, taxes are paid. Remember the revenues to the government are enhanced when interest income and a gain on the sale of stock are reported.

5. John S. Herold, Inc. uses an appraisal technique that involves analyzing a company by its components. Herold is not, however, analyzing the breakup value of a company. For instance, if it were breakup value, Herold would have to evaluate existing or future income taxes that would result from the sale of certain assets versus operating those assets. Herold does not make this kind of analysis.

(a) The opportunity for a friendly or hostile acquiror exists when there is a disparity in the appraised value and the market value of the company. If the company has maintained values for stockholders it is not vulnerable.

In the energy industry alone, if the ten largest companies brought their market value up to 75% of appraised value, the four million stockholders who own these companies would enjoy an increase in the value of their stock of $75 billion. The federal government would make about $20 billion. (See attached memo.)

(b) Mesa's expertise is in the oil industry. Certainly, there have been takeover attempts, both friendly and hostile, in many other industries where others have perceived that unrealized values exist. I am not an authority in other industries, however, and therefore I am not qualified to comment in any greater detail on this question.

6. Mesa Partners II was a partnership created to acquire Unocal stock. Therefore, Mesa Partners II has no other assets or operations. Had Mesa Partners II acquired 50% of Unocal stock, bonds would have been issued to acquire the other 50%, and at that time we would have put more than $1.5 billion in equity into Mesa Partners II. It is on the strength of that equity that the bonds were to be issued. Mesa's assets would have made up 90% of the $1.5 billion with the other 10% put up by the other participants in Mesa Partners II. Obviously, Mesa's assets would have been at risk.

One additional point. With that kind of money at risk, it should be obvious that we were sincere in our efforts to buy and operate Unocal, not to destroy it.

7. Because the tender offer was not successful, many costs related to it, including financing commitment fees, are deductible under the Internal Revenue Code. If our offer had not been short-stopped, the costs would have been capitalized as part of the acquisition and deducted over time.

8. Mesa's bank loan agreement allows Mesa to pay a quarterly dividend up to 10 cents per share without bank consent. However, sales of assets in most cases require partial repayment of the loans.

9. Attached is a chart showing a breakdown of the transactions that shows taxes to the government from the Mesa deals of about $3.5 billion. We arrived at that figure by assuming an overall effective tax rate of 30%.

Thank you for the opportunity to answer your questions. Clearly you and I don't agree on all of the issues or your legislation would be different. I hope we will have a chance to discuss its specifics.

In the meantime, included are a series of articles that further illuminate the issues related to mergers and acquisitions.

Sincerely,

T. BOONE PICKENS, JR.

Attachments.

ANALYSIS OF SELECTED MERGERS

	Per-merger price per share	Stock price all-time high (year)	Price per share achieved	Percentage increase over premerger price	Number of shareholders	In millions: Gain to shareholders	In millions: Estimated Federal income taxes
Cities Service	$30	$68 (1981)	$52	73	150,000	$2,000	$600
General American Oil	30	57 (1980)	45	50	20,000	375	110
Gulf	40	54 (1980)	80	100	400,000	6,600	2,000
Phillips	35	63 (1980)	53	51	200,000	2,775	830
Totals					770,000	11,750	3,540

To. T. Boone Pickens, Jr.
Date: March 28, 1985.
Subject: 75 Percent Appraised Value Chart.

The chart below was compiled by Sidney and shows that if the ten companies listed were able to bring market value up to 75% of appraised value, they would see a total increase of $75,464 million. Four million shareholders would enjoy $75 billion.

	Shares (millions)	J. S. Herold value per share		March 12 close stock price	Appreciation to 75 percent (millions)
		Actual	75 percent		
Company:					
Chevron	342.1	$108.85	$81.64	34.125	$16,255
Exxon	816.1	77.70	58.28	50.00	6,753
Mobil	411.4	88.35	66.26	30.00	14,918
Texaco	241.6	99.95	74.96	35.25	9,594
Arco	248.0	122.40	91.80	48.75	10,676
Amoco	270.3	108.45	81.33	62.75	5,024
Sohio	240.0	101.85	76.39	45.50	7,414
Sun	117.2	88.35	66.26	50.125	1,891
Unocal	173.7	76.45	57.34	46.875	1,817
Occidental	96	53.25	39.94	28.25	1,122
Total					75,464

[From the Wall Street Journal, May 31, 1985]

High-Yield Bonds Aren't "Junk"

(By Frederick H. Joseph)

Heated rhetoric generated by recent hostile takeover controversies is giving high-yield bonds a bad name; by now everyone has heard the pejorative "junk bonds." This loaded language does nothing to clarify the facts.

Indeed, high-yield bonds have somehow been linked with a number of unrelated issues, such as fraudulent activities at E.S.M. Government Securities Inc., the financial problems of thrift institutions, bad commercial lending by certain U.S. banks, foreign loans, the overleveraging of America, practices of corporate predators and greenmail. Problems do exist in the financial markets, demonstrated by the thrifts' recurring difficulties and the bankruptcies of government securities dealers. However, these difficulties are totally unrelated to high-yield bonds. As far as we know, for example, none of the Ohio or Maryland savings and loans that encountered difficulties owned any such bonds.

Some bonds in the investment markets have always offered above-average yields, but historically these were bonds that had declined in value after originally having been issued as investment grade. When we at Drexel Burnham Lambert pioneered newly issued high-yield bonds, the innovation provided access to public capital markets to companies rated below investment grade, typically including the economy's most promising enterprises.

It is critical to understand that only 675 U.S. companies have been rated investment grade by the major rating agencies, though there are 20,000 companies with assets in excess of $25 million. In making ratings, Moody's and Standard & Poor's rely heavily on historic data ansize, which are not necessarily valid indicators of future capability to service debt.

High-yield bonds effectively replace the private term loans traditionally made by insurance companies. Investors are protected from changing circumstances by market liquidity instead of the less efficient mechanisms of restrictive covenants found in private placement agreements.

DOWNGRADING CAUSES LOSS

The newly issued high-yield bond market emerged in 1977 when approximately $900 million of bonds were issued by mid-size and growing companies. The market has grown fairly steadily, reaching $14 billion of new issues in 1984. More than 350

companies have used the public market to issue $35 billion of high-yield debt since 1977. Many of these, such as Humana Inc., MCI Communications, Coastal Corp., Beverly Enterprises, People Express and Kinder-Care, have recorded impressive results and have enhanced the growth of the nation's economy. Far more jobs are being created by small and midsize companies than by the relatively few larger ones. In fact, Fortune 500 companies have seen net losses of jobs in recent years.

Institutional investors who buy corporate bonds are essentially risk-averse. This has led to a somewhat inefficient market that pays investors premiums for accepting incremental risk. It has been proved empirically that these premiums are well in excess of the actual increase in risk and, with premium returns averaging four to eight times the actual increase in risk, high-yield bonds have been an unusually successful investment vehicle. In fact, more money has been lost in the bond markets through the downgrading of investment grade debt than through defaults of below investment grade issues.

Confirmation of high-yield performance is available in a number of academic studies. An analysis by the Wharton School of the University of Pennsylvania of investment return for the period of January 1980 to June 1984 found that below investment grade bonds produced a total return of 13.5% a year, almost double the 7.2% return for Triple-A corporate bonds. The Wharton study concludes that, "In the context of a well-diversified portfolio, the risk of lower-quality bonds was no greater than the risk of high-quality bonds."

Furthermore, defaults have been below expectations. A New York University study found that from 1974 to 1984, although the default rate on high-yield bonds was higher than for all corporate bonds, the actual losses were only about 1% because the defaulted bonds retained about 41% of their par value. The NYU study concluded that even including losses from defaults, the high-yield sector outperformed Treasurys by an annual average of about 5% to 6% from 1978 to 1983.

As with any quality of bonds, investors should diversify portfolios of high-yield bonds, as do the investment professionals who dominate this market.

Despite the press attention high-yield bonds have attracted, they have not been a major source of funding for mergers and acquisitions. Of the $122 billion used to finance mergers and acquisitions in 1984, less than 2% came from high-yield bonds. Most of these activities were financed by cash, bank borrowings or internally generated cash flow. Commitments to fund attempted takeovers with high-yield bonds have been greater this year, but have actually been exercised only in the highly regarded hostile-turned-friendly acquisition of American Natural Resources by Coastal Corp. Understandably, some managements of large companies, previously impregnable to challenge because of sheer size alone, view with alarm the ability of smaller companies to mount takeover bids backed by public debt. However, the discipline imposed by this potential competition is certainly a positive development.

There also have been claims that high-yield bonds structured for use in recent takeovers are of low quality, thereby discrediting historic default ratios as a measure of future security. However, no knowledgeable credit analyst who has reviewed these securities would agree with that assertion. On the contrary, because of the hostile environment and the speed with which such financings must be arranged, these issues have been of higher credit quality than other issues providing comparable returns. They have been carefully structured to provide significant protection to the institutional purchasers.

While reasonable people may differ on the merits of hostile takeovers, there is certainly significant evidence that such free-market activities benefit the economy as a whole. In a study in the Harvard Business Review, Prof. Michael Jensen found that "scientific evidence indicates that activities in the market for corporate control almost uniformly increase efficiency and shareholders' wealth."

A similar conclusion was drawn by President Reagan's Council of Economic Advisers. In its 1985 report, the CEA concludes that competition plays a central role in the evolution of the economy. "[It] breaks down entrenched market positions, unsettles comfortable managerial lives and provides incentives for innovative forms of business organization and finance."

An argument against takeovers is that the successful bidder must sell off assets to pay the acquisition debt of that the corporation that mounts a successful defense does so by leveraging itself. This restructuring, particularly in the case of the oil industry, is caused by real economic forces independent of takeovers, although timing and the particular measures adopted have been influenced by takeover activity. Atlantic Richfield recently adopted a restructuring program that will ultimately produce a higher dividend, fewer shares outstanding and higher earnings per share. Exxon is continuing its efforts to improve the return on shareholder equity. The company has repurchased some 96 million shares, or 11% of its previous common-

share capitalization. Meanwhile, Exxon has *more* capital and exploration expenditures for 1985 than in 1984.

Whether the restructuring of the oil industry bodes well for our economy, time will tell. We do know that no pressure was brought to bear on managements in the steel industry 15 years ago. They did not restructure their companies and the nation is faced today with the results of their failure to act. Perhaps it is time to try another approach.

DIVERSIFICATION IS CRITICAL

Another red herring focuses on the role federally insured thrifts play as a purported major source of capital to finance takeovers. This position stems from the mistaken belief that S&Ls have been major participants in takeover financings.

In fact, thrifts have been relatively small participants in the newly issued high-yield bond market. We estimate they hold between $3 billion to $5 billion of these securities. The Depository Institutions Deregulation Act of 1982 wisely authorizes such investments by thrifts to allow them to improve their risk-adjusted returns toward levels necessary to ensure their long-term viability. Clearly, such investments should be made prudently, subject to professional credit analysis within the thrift or retained by them on a pooled basis. Diversification, which is critical to the success of such an investment program, should be required, if not voluntarily pursued. Based on all available historic and current data, these investments will continue to provide above-average risk-adjusted returns to thrifts, in addition to the liquidity absent in mortgage and commercial loans.

Corporate takeover activity is a matter that deserves careful deliberation. In specific cases legislation may make sense to ensure that both the aggressor and target company have a fair opportunity to act responsibility. (For example the 10-day notification requirement under rule 13D creates opportunities for abuse and should be addressed.) But loaded words and dramatic rhetoric only cloud the discussion and make it more difficult to deal with these complex market events.

High-yield bonds are not the cause of takeovers, nor are they the primary source of capital used to finance them. They are the financial instruments used to provide midsize growth companies with access to the public market for capital and, as such, they have made a substantial contribution to our economic vitality and ability to compete globally.

[From the Wall Street Journal, June 5, 1985]

TAKEOVERS: THE MARKET TEST

[Capitalism, then, is by nature a form or method of economic change and not only never is but never can be stationary. . . . The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates. . . .

[The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory to such concerns as U.S. Steel illustrate the same process or industrial mutation–if I may use that biological term–that instantly revolutionizes the economic structure from within, incessantly destroying the old, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in. . . .

[[T]he problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them.—Joseph A. Shumpeter "Capitalism, Socialism and Democracy"]

So the greatest economist of our century described the essence of capitalism. And after listening to the big debate on corporate takeovers this year, we found our way back to his great book and particularly the chapter "The Process of Creative Destruction." For the longer we've thought about the subject the less we've come to fear a "takeover mania." Instead we fear some heavy-handed congressional regulation, if indeed the Delaware Supreme Court has not already gone too far with its recent ruling handling managements new defensive powers. The danger in inhibiting takeovers is cutting off Shumpeter's creative destruction

Readers of this page have been able to follow a remarkable airing of the sides of the takeover debate: raider Sir James Goldsmith (Feb. 11), poison-pill inventor Martin Lipton (April 5), investment banker Felix Rohatyn (April 18), Prof. William J. Carney of Emory University (April 29), Gregg Jarrell and Kenneth Lehn of the

SEC (May 1), Sen. Pete Domenici on his bill to regulate takeovers (May 14), Frederick Joseph of Drexel Burnham Lambert in defense of "junk bonds" (May 31).

Critics of takeovers like Mr. Lipton, Mr. Rohatyn and Sen. Domenici have undoubtedly been able to identify some problems. But many of them are either not unique to takeovers are eiter not unique to takeovers (high leverage) or already being sorted out in the marketplace (greenmail). On balance we have been more impressed by the arguments of the defenders. In particular, they can show that much of what is being criticized is legitimate investment banking—creating new financial instruments and new corporate structures more suited to the contemporary marketplace.

This is perhaps most easily seen by focusing on one issue, the "restructuring" of the oil industry. T. Boone Pickens gave his views on this issue in a Jan. 8 letter, and it was addressed quite independently of the takeover battles in a Feb. 21 article by John Sawmill of McKinsey & Co. The turbulence of energy prices in the 1970s has completely changed the environment for the oil industry, creating a glut of refinery capacity, leaving producing nations rather than international companies in control of oil reserves and greatly enhancing the importance of the spot market for crude oil. In these new conditions, the traditional vertically integrated oil company is no longer necessarily the best answer for either the investor or the consumer.

The problem is how to shed inefficient refinery capacity, take advantage of the spot market, and return cash flows from oil production to the capital markets so they can be redirected to other opportunities. It is not impossible to do this within the structure of present oil companies; refineries and retail outlets are being closed. Exxon, surely not under any takeover threat, has repurchased some of its shares, a way of returning money to the capital markets. But inertia attaches to any large bureaucratic structure, and even when raiders have not succeeded in ousting managements they have often been the catalysts for necessary restructuring.

This is certainly not to say that every takeover proposal is economically justified, let alone that the raiders are motivated by a public-spirited desire to improve economic efficiency. But legislators or judges who have to decide on takeover law ought to read "The Market for Corporate Control" in February's report by the Council of Economic Advisers, which concluded that takeovers add to economic efficiency and wealth, and should not be discouraged but encouraged.

In particular, it's important to remember that greed is disciplined by the marketplace, that by and large takeovers succeed only if a broadly diversified market approves. Wall Street still echoes with laughter at the cashless bid for CBS by Ted Turner, who is probably not motivated solely by economic considerations. Few such flimsy offers ever reach public prints. More often raiders are going to pick companies on which they think they can make money, junk bond dealers and buyers will back deals on which they think they can make money, the arbitragers will buy only if they think they can make money on a successful deal. And shareholders will sell only if the stock price goes up.

The market test of hostile takeovers may not provide absolute proof that every deal is an example of Creative Destruction at work. But the market, we submit, is a far better test than anything Congress is likely to devise.

[From the New York Times, May 29, 1985]

Who's Afraid of the Big Bad Merger?

The largest industrial merger ever proposed—the betrothal of the Allied and Signal Corporations—raises anew an issue Americans have debated for a century. Does the creation of ever-larger corporations threaten the economy?

Big mergers are again the vogue and they make many Americans nervous, particularly when they promise no obvious efficiencies. But it is hard to point to any automatic harm that they would inflict, economic or political. And since some mergers do serve a public interest, the burden of proving damage rests on those who argue that bigness is inherently bad.

The classic goal of mergers is monopoly power, the ability to raise prices without losing sales to competitors. That was certainly the motive for creating "trusts" in tobacco, oil and other industries late in the 19th century.

Combinations of that kind are forbidden by the Sherman and Clayton Acts. Academics can keep themselves occupied arguing the fine points, but there's little question that the Government has been committed to blocking combinations that create market power. For example, oil company mergers that increased concentration in local markets were undone by Federal antitrusters.

But there is also a subtler, political issue. Some analysts believe that big companies use their enhanced financial muscle to gain advantages in the political arena that they would not otherwise achieve in the marketplace. Big companies are well placed to purchase the goodwill of elected officials with campaign contributions. Ironically, however, they rarely do as well politically as smaller companies that stand together on specific issues.

Look again at oil. In the past decade, the big integrated oil companies have lost some of their special tax privileges, lost battles to open offshore sites to drilling and failed to gain the decontrol of their natural gas reserves. But Little Oil, the not-so-little companies that have made hundreds of individuals wealthy, have won special tax depletion allowances, escaped from windfall profit taxes and have been allowed to buy crude oil below market price and to charge top dollar for natural gas. Little Oil's success owes much to its low public profile, its unity of purpose and limited political goals. Bigger companies like Mobil may be able to afford the slickest lobbyists, the biggest and best ads and the fattest campaign contributions, but their influence is often weakened by internal conflict.

For example, while import quotas on gasoline would benefit Mobil's domestic refineries, they would injure its European refineries exporting to America. Moreover, Mobil could never afford to pull out all stops to change a single obscure provision of the tax code without dissipating its ability to lobby for a dozen other tax decisions.

Little Oil is hardly alone in its special power. Little truckers used to run rings around big railroads at the Interstate Commerce Commission. Soft-drink bottlers manage to maintain a virtual exemption from the antitrust laws, which makes them the envy of name-brand manufacturers. Dairy farmers regularly clobber the attempts of giant food processers to lower price supports.

Does all this mean society should be more sympathetic to big mergers and ever-bigger corporations? It should certainly be more selective in its concerns. The current consolidation in the oil industry is probably a good thing, shaking up sleepy managements and lowering the cost of equity capital. Mergers in transportation probably reflect a need to adjust to the new realities of competition.

Some mergers, however, occur simply because investment bankers promoted them for consulting fees, or because mediocre managements saw no better ways to grow or solve internal problems. These should raise doubts about the flexibility or inventiveness of corporate bureaucracies.

The right test of a merger is not simply its size but its sense.

[From the Dallas Morning News, May 28, 1985]

Corporate Bad Guys: Robin Hoods?

RAIDERS HELP SHAREHOLDERS BY BOOSTING COMPANIES' UNDERVALUED STOCK

(By James J. Mitchell)

Top corporate executives throughout the country should be resting a bit easier these days. T. Boone Pickens has been thwarted in his attempt to take over Unocal Corp., and companies have a new weapon to use against corporate raiders.

But what the executives have won, investors have lost. Despite their arrogance and the generally unfavorable press they received, the raiders earned investors hundreds of millions of dollars. Without T. Boone Pickens, for example, investors in Gulf Corp., Phillips Petroleum Co., Cities Service Co. and Unocal would be far poorer than they are today.

And indeed, this country's market system also may have been harmed a bit. One of the strengths of our system is the mobility of capital and the responsiveness of capital to opportunities. In the wake of Pickens' defeat, that responsiveness has diminished.

Much of the coverage of the raiders has focused on their flamboyance, their huge war chests, their underhanded tactics (who, after all, could approve of something called greenmail?) and the anguished cries of their targets.

Trans World Airlines Inc. executives, for example, get headlines and long stories when they complain about Carl Icahn's proposed takeover. But individual investors who stand to earn an extra few hundred or few thousand dollars are ignored.

Most of us forget that one of the principal effects the raiders have is to force the marketplace to take a second look at the value of companies the raiders invest in. And when investors take that second look, the value of the targets' shares frequently jumps between 30 percent and 50 percent.

The reason for this gain, the raiders say, is that investors realize that if the raiders succeed, they'll replace top management with a team that will do a better job for shareholders. Icahn likes to talk about Pickens' effect on Phillips stock. With its old management, investors thought Phillips was worth $35 a share, Icahn says. With the prospect of new management, they thought it was worth $60.

Even when they don't try to take over a firm, raiders do serve a useful purpose as a management prod. Atlantic Richfield Co., for example, recently started selling some of its holdings and buying back its stock in part because it didn't want to be the target of a raid. As a result, the stock has risen about 20 percent.

Raiders choose as targets companies they believe are poorly managed, have made poor investments over the years, aren't getting the proper return on assets and don't care about their shareholders, Icahn says.

Usually, these companies' managements have created a bureaucracy that's expensive and ineffective, he says. Their top executives are people who did well on the division level but came to care too much about perks and parties after reaching the top, he notes. And these firms' boards of directors are "a farce" because the directors form a clique where "each votes on each other's bonuses," he says.

Icahn believes many American executives have wrong priorities. In the United States, executives have beautiful offices while the companies' machinery is falling apart. In Japan, on the other hand, executives have no offices but the companies do have top-notch factories. "That's the way it should be," he said.

He cites Chrysler Corp. under Lee Iacocca as an example of what new management can do. Under its old management, "Chrysler would have been shut down," he said.

Executives of takeover targets disagree with Icahn's analysis, of course. But they usually agree that their shares are undervalued.

In recent years, in fact, many companies' top managements have taken their companies private by purchasing all the outstanding shares. In most cases, these managers have made significant profits even though they paid a premium over what had been the market price of their shares.

Since those takeovers were done by insiders, few complained about the tactics.

Even before the Pickens defeat, which was caused by an adverse ruling by the Delaware Supreme Court, it wasn't easy to be a raider. It took a multimillion-dollar bank roll, the ability to raise hundreds of millions more, lots of nerve, and extremely thick skin and the savvy to pick the right target and execute the takeover properly.

Unfortunately for investors, it will now be even more difficult.

[From Business Week, May 20, 1985]

Will Mergers and Buybacks Now Really Mean Less Oil Later?

(By Anthony J. Parisi)

Analysts love to accuse big companies of sacrificing the long run for the short, and often they are right. But sometimes they are wrong—as they probably are in the current controversy over how the consolidation under way in the oil industry will affect domestic exploration.

The argument goes like this: By spending their available cash buying up their stock and by saddling themselves with debt to pull off mergers, the companies are mortgaging the nation's oil supply and hence its future. Better they should drill for oil, the critics say, because one day the glut will end and the oil will be needed.

The key phrase is "one day." No one knows when the crossover will come, of course, but the time frame usually cited is the 1990s. Even assuming that this forecast proves correct—and it is debatable—the argument is one-dimensional. It ignores some economic axioms that might lead to a very different conclusion:

Money spent looking for oil does not earn interest. The market price of oil in the U.S. is now about $27 a bbl. Although no one knows for sure, the average cost of finding a barrel of oil is generally put at less than half that amount. At the margin, however, an oil company will consider spending up to $27 a bbl. on an exploration project—unless it thinks further price declines are coming.

But if you put, say, $25 in a tax-free bond paying 10%, it would grow to nearly $65 by 1995—at very little risk. Unless the price of oil is at least that high by then, the company is ahead of the game by not drilling. And these days the experts who still predict $65 oil for 1995 are only slightly more numerous than the oil industry CEO s who consider Boone Pickens an American Robin Hood.

Money spent looking for oil cannot be invested elsewhere. Just because we may someday need to drill more doesn't mean we should drill more now. Opportunities are always lost when money is spent. Thus, associated with any decision to invest in a wildcat well is what economists call "opportunity cost," the cost of forgoing all those other possibilities.

One of the endless things the money could have financed might pay off even bigger than a new field—not just for the company but for society as a whole. Funds recycled to oil company shareholders could find their way to entrepreneurs who would spark another high-tech revolution, creating the wealth to buy the oil that wasn't produced—and then some. The money might even finance an invention that makes oil obsolete.

Investments turn on their yields, not on cash hoards. If an oil company decides not to spend its money buying another oil company, it probably won't drill more anyway. If the investment in exploration wasn't attractive before, it won't be attractive after, all else being equal. The cash will simply be spent some other way.

The prime determining factor in the decision to drill is the price of oil. If it is high enough relative to the expected cost to find and produce the oil, someone will put up the money. If it isn't, not even an oil company stuffed with cash will take the risk.

Curiously, none of these arguments seemed to matter in the days of shortages, either. Back then, critics complained that the oil companies should drill more holes with their high profits, not buy department stores. They also demanded that the big oil companies be "dismembered," or broken up into producers, refiners, distributors, and retailers, to ensure that no one player had a lock on the business. The companies responded that stripping them of their profitable "downstream" assets would make it more difficult for them to find all the oil America needed. Neither side, it would seem, had the underlying economics in proper perspective at that time, either.

Now that Arco, Exxon, and others are buying back their stock, critics are carping again—using the same line they did the last time. The debts that some oil companies are taking on to buy other oil companies, the critics add, will make it more difficult for the survivors to explore for new oil. Same argument, same shortcomings.

The truth is that no one knows what any of these moves will mean, just as no one knew what all those moves meant the last time around. The only thing we do know is that the markets—the millions of investors who collectively weigh the merits of these things—think they are good. And they just might be right.

[From the New York Times, May 7, 1985]

Price Decline Spurs Change

(By Thomas C. Hayes)

Los Angeles, May 6—One after another, the big oil companies have been forced to react to cheaper oil.

Their moves have included desperate mergers by Gulf with Chevron and by Getty with Texaco to escape takeovers; stock repurchase programs by Exxon and Amoco, and major restructuring by Atlantic Richfield, which will close some businesses and pare back others.

Today's announcement by the Mobil Corporation that it would jettison its troubled retailing unit, Montgomery Ward, by transferring ownership directly to its stockholders, made Mobil one of the latest of the oil giants to embark on a significant rearrangement of its assets.

Although the responses have varied, they all represent efforts by an industry hobbled by too much oil, too much refining capacity, too many people and too little current promise in its basic business—the search for oil. And as far-reaching as the restructuring moves appear to be, experts say there will still be more.

"The downturn in prices that began in 1983 looks like the beginning of a decade-long process," said Thomas A. Petrie, a managing director and senior oil analyst with the First Boston Corporation, in Denver. "That leaves managers to conclude that there are profound differences in the way they should run their business."

Many in the industry point to T. Boone Pickens, chairman of Mesa Petroleum, as the ubiquitous agent behind the changes that are jarring the industry. He battled the Gulf Oil Corporation, was an early agitator at the Getty Oil Company, and pursued Great American, Superior Oil and Cities Service into the arms of friendly ac-

quirers. He also initiated the original bid that forced the restructuring of Phillips Petroleum, a bid later pursued by Carl C. Icahn, the financier. But while Mr. Pickens appears to have played a key role in the industry's restructuring, some analysts maintain that the drama would probably have occurred sooner or later, even without him.

"IT NEEDS RESTRUCTURING"

"The oil industry is maturing, and it needs restructuring," said Robert Stobaugh, head of the Energy Project at the Harvard Business School. "If Pickens had not come along and done this, somebody else would have."

The results of the restructuring are still the subject of debate. Some, like Philip K. Verleger, Jr., an oil economist affiliated with the Charles River Associates, a consulting concern, argue that the industry could be hampered by the changes, particularly the big increases in debt. "There will be less oil found," he said, as a result of the industry's rising debt.

Others, including M.A. Adelman, an economics professor at the Massachusetts Institute of Technology, contend that, for all the turmoil, the industry is healthy.

The number of oil wells drilled in 1984, for instance, was up nearly 11 percent from the previous year, to 41,095, according to the American Petroleum Institute.

"What the industry did in the early 80's was overshoot, and it's come in for a surprisingly soft landing," he said. "I don't think these consolidations make much difference."

For now, uncertainty about oil prices and new tax laws, which would remove breaks for oil drillers, has put a recent damper on oilfield activity. The number of active drilling rigs fell to 1,855 during the week of April 29, from 2,713 in the last week in December. It was lowest level since drilling activity bottomed at 1,877 rigs in April 1983, according to the Hughes Tool Company.

It was only a few years ago that the American oil industry was drafting its future on the assumption of ever-rising oil prices. Although gasoline use picked up a little, overall demand for crude oil last year in the United States was about 15.6 million barrels a day, or well below the peak average of 18.8 million barrels in 1978.

Gains from conservation, which are still rising, have demonstrated the industry's woeful underestimation of oil's price elasticity—how much consumers could and would cut back in the face of higher prices.

In 1973, the year of the Arab oil embargo, the United States consumed 60,000 British thermal units of energy for every dollar of gross national product. Last year, with a barrel of Saudi Light crude oil averaging $28, compared with an average of $3.89 a barrel in 1973, the figure had fallen to 42,000 B.T.U.'s per dollar of G.N.P. A B.T.U. is the amount of heat needed to increase the temperature of a pound of water by one degree Fahrenheit.

World oil prices have been surprisingly steady this spring, largely because of production cutbacks in Saudi Arabia. Still, many analysts predict that prices will fall by another few dollars if the Saudis increase their output, as expected, to between 4 million and 5 million barrels a day from 3.8 million barrels in the first quarter.

Costs for exploration and development of new reserves in the United States have fallen since the wildcatting frenzy of 1980 and 1981. Yet drilling opportunities in the nation have wanted after more than a century of prospecting. And foreign activity is regarded as politically risky.

So, many companies have cut back on spending for exploration and development. This enables them to borrow more, since they have reduced risk in their oil operations, but they still have big cash flows, according to Ronald M. Freeman, managing director and head of the energy group at Salomon Brothers, the investment bankers.

Atlantic Richfield, which has large Alaskan oil reserves, raised its annual dividend by a $1, to $4, and inaugurated a plan to borrow heavily to raise the $4 billion it needed to buy back shares. Its debt as a percent of total capital would rise to 63.5 percent by the end of the year, from 32.5 percent at the end of 1984, if the buyback is completed this year and the company does not pay off other debts.

Arco also said it would abandon the money-losing gasoline refining and marketing business east of the Mississippi River. The idea of coast-to-coast marketing networks, once the pride of companies like Texaco, Exxon, Arco and others, became wasteful in part because of big inventories needed to supply the networks.

"Arco looks very, very smart, and the stock market is saying that," Mr. Freeman said. The company's shares have jumped about $10, to a close today of $63.25, since the restructuring announcement on April 29.

Exxon has taken a different route to raise its stock price. The nation's largest oil company has already spent $4.3 billion to buy back 11.8 percent, or 102 million, of its share, in the last 18 months. It earlier wrote off $30 million from its investment in office automation, but kept its debt as a percent of total capital at a low 17 percent, at the end of 1984.

MOVES AT AMOCO

Amoco, formerly the Standard Oil Company (Indiana), spent $1.7 billion from last May through April 23 to buy back 27.4 million shares. The program will end when it reaches 30 million shares, or 10 percent of the company's total. Amoco has also handed ownership of its struggling minerals business to its shareholders, and it has cut 3,300 jobs and sold parts of its chemical business and its Australian operations.

Still, unlike Atlantic Richfield and others cutting back on exploration, Amoco is plunging ahead. Its budget for capital spending is up 15 percent this year, to $5.1 billion.

Meanwhile, Chevron, which acquired Gulf Oil for $13.2 billion a year ago, and Texaco, which bought Getty Oil for $10.1 billion, are awash in the debt used to finance the purchases. Both have struggled to cut costs. Their stockholders have seen little appreciation in the stock values since the takeovers, which raised their domestic oil reserves but duplicated many administrative functions, a year ago.

[From Newsweek, May 6, 1985]

IN PRAISE OF BOONE

(By Robert J. Samuelson)

Let us now praise the Boone Pickenses of the world.

They're parodied as capitalism's juvenile delinquents: corporate "raiders" engaged in "hostile" takeovers financed by "junk" bonds. In fact, hostile takeovers are not simply a giant Monopoly game played for private gain and social loss. They represent a crude check on the power of corporate managers to waste wealth and create inefficiency. I doubt those in Congress who condemn Pickens and want to regulate takeovers understand the distinction.

The ultimate social role of business is to enhance national living standards and competitiveness. Mismanagement has social consequences. In Britain, investment as a proportion of national output has been higher than in the United States. But our investment is 60 percent more productive because American companies invest more wisely and use their investments more efficiently. I am not arguing, therefore, that most management is incompetent or that most investment is made whimsically.

But hostile takeovers represent a healthy reaction to flaws in our business system. When corporate managers are not the major owners of their companies—as most are not—their loyalties become confused. They may be less interested in maximizing profits than in preserving and expanding their corporate domain. By contrast, society's interest lies in maximizing efficiency and living standards; profitability—which means companies producing what people want and doing so efficiently—is a social, not just a business, indicator.

MATURE MARKETS

As long as a company's primary business is thriving, the conflict may lie dormant. Managers can maximize profits and expand simultaneously. But this happy marriage rarely lasts forever. Almost all products have life cycles. Markets mature, and traditional products often generate more cash than can profitably be reinvested in the same product. Corporate management then faces a dilemma: to over-invest in a mature business, or to diversify into a new business, where the company may have no special knowledge or talent.

Hostile takeovers arise mainly to exploit profit opportunities created when corporations cannot cope with their growth dilemmas. Some firms can diversify successfully, others cannot. In some, the force of habit compels them to invest in declining businesses. Given the impulse for survival, managements only grudgingly react to a paucity of internal investment opportunities by paying more of their cash flow to shareholders, who would then reinvest for themselves.

The oil industry epitomizes the process. It has a huge cash flow and scarce reinvestment opportunities. Plowing money back into oil erodes profitability. Consider Phillips Petroleum, a Pickens target. Between 1974 and 1980 its rate of return on

shareholders' investment averaged 18 percent; in the last four years the return has averaged 13 percent. Some oil companies have acknowledged this situation by buying back their stock, which raises the price of the remaining shares. In 1984 six firms, led by Exxon, repurchased $5.7 billion of shares.

Pickens's maneuvering has aimed at achieving a similar result elsewhere. For example, Phillips ultimately gave existing shareholders debt securities, which commit the company to paying out much of its cash flow as interest payments. Gulf was purchased by Chevron for $13.2 billion. Gulf's shareholders were paid off, and much of the cash flow of the new company will repay the loans used to finance the merger. Again, funds flow from the oil industry into more profitable uses. Since 1981 oil drilling has fallen nearly 40 percent.

The question naturally arises: is what's good for Boone good for the country? My hunch is yes. There's a fixed amount of oil left in the United States, and it's increasingly costly to find and extract. The poor profitability of new exploration reflects these high finding costs and falling world oil prices, a sign of plentiful supplies. As a nation, there's no point in rushing to deplete domestic reserves while international supplies are ample. When they aren't, prices will rise and make recovery more profitable.

I admit that Pickens and other takeover specialists don't inspire much sympathy. We envy their wealth and resent the apparent ease by which it was acquired. The error, though, is to see profits only as a guage of private greed. It also measures social utility. Anything that shifts investment to more profitable uses—or spurs efficiency—improves our collective welfare.

BAD MERGERS

In part, today's hostile takeovers represent a corrective for yesterday's abuses. Wasteful corporate diversification via mergers has been a major misuse of management autonomy, fed by tax policies that discourage dividends and encourage borrowing. (The interest payments on debt are deductible, while dividends are taxed at both the corporate and personal levels.) Many companies have become cumbersome empires; they cannot motivate workers or be managed effectively.

It is precisely these companies that emerges as potential takeover targets. If CBS is at all vulnerable to Ted Turner, it is not because the network is poorly run; it is because the breakup value of the CBS conglomerate—which includes toys, records and magazines—may be worth more than the combined company. Even the distant threat of a takeover can be therapeutic. Companies are furiously selling unwanted divisions and subsidiaries; according to W. T. Grimm & Co., more than a third of acquistion activity now represents sell-offs.

The sin of Pickens and other takeover specialists is to discomfort the barons of business, who are now running to Washington for protection. Corporate executives reserve to themselves the right to buy and sell divisions, open and close factories, change products and shift strategies. But when someone suggests changing corporate leadership, then America's board-room chiefs piously declare the sanctity—as The Business Roundtable puts it—of preserving "the long-term viability of a corporation."

This is sheer hypocrisy. Most corporations can adequately contest takeovers. Congress should limit artificial tax incentives for mergers of all sorts. But it doesn't need to protect already entrenched managements. Can you imagine a group less deserving of help? I can't.

[From the New York Times, May 5, 1985]

ARCO'S ANSWER TO T. BOONE PICKENS

(By John C. Sawhill)

Last week may have marked a turning point for the energy industry. Until then, it was not clear who would undertake the necessary restructuring of the industry—management or corporate raiders such as T. Boone Pickens, chairman of the Mesa Petroleum Company. But Atlantic Richfield's announcement of plans to significantly reduce its investments and assets may have served notice that what the raiders started, management will finish.

The energy industry today is facing difficult but not intractable problems. Deregulation, falling oil and gas prices and declining demand have created overcapacity in almost every part of the business. Management has to respond to these changes

with something more than business as usual, for the old ways simply play into the raiders' hands.

This is exactly what Arco has done. Its decision to sell its East Coast refinery operations and service stations and to cut its budget for exploration and production by 25 percent (in addition to buying back $4 billion of its stock) represents a bold move away from the long-held notion that companies had to be vertically integrated, with operations in all segments of the oil industry—from exploration and production to refining and retail sales.

In the past, companies without a presence in all these areas were penalized because the poorly developed spot market made it difficult to buy and sell crude oil and petroleum products for day-to-day operations. Today, however, trading on the spot market is commonplace, and most refineries have the flexibility to process a wide variety of crudes. There is little advantage to maintaining refineries solely to process your own crude, particularly when these operations have lost $6 billion in the United States in the last two years. The advantage of integration has all but disappeared.

Arco's plan to cut its exploration and production budget suggests that other segments of the business are also experiencing profit pressures. In fact, returns to the domestic exploration and production industry have fallen short of the cost of capital since 1979.

But oil executives have been slow to recognize these changes. So, their companies' large cash flows and underutilized debt, capacity have become irresistible lures for takeover specialists. Raiders have promised to direct the cash toward more profitable businesses or give it back to stockholders.

Many executives say their options are limited to short-term fixes because predators prevent them from thinking long term. That's not the case and companies such as Arco are proving it.

They are doing the following:

SELLING OFF UNDERVALUED ASSETS

Raiders often look for undervalued assets and propose a restructuring to realize their true market value. A classic example of this technique was Mr. Pickens's proposal to put Gulf's production properties into a royalty trust for the benefit of stockholders. At Transco, an alert management pre-empted this opportunity for raiders by giving stockholders an interest in the company's oil production, and as a result increased their stock price by about 20 percent. But top managers in general are reluctant to sell assets because they don't recognize that integration is not the path to stability and security that it once was. In fact, to the extent that integration leads to undervalued assets, it has just the opposite effect.

GETTING RID OF LOW-PROFIT OPERATIONS

Arco's decision to cut back its bulk chemical business is a good example. Pipeline companies that have unsuccessfully diversified might also consider this option. American Natural Resources entered the trucking business apparently to take advantage of its skills in operating in a regulated environment. When trucking was deregulated, however, this rationale vanished. Yet A.N.R. has poured $95 million into trucking over the past four years, with losses totaling $47 million. Stockholders might have been better served if the trucking subsidiary had been spun off.

IMPROVING PROFITS

Losing operations often don't get scrutinized because transfer prices or overhead allocations hide their losses. In fact, sometimes these "adjustments" are made to minimize taxes or to improve reported profits, which disguise the unit's true performance.

EXPLORING MERGERS

As natural gas prices have been deregulated, the gas pipeline industry has experienced a rash of mergers and acquisitions, of which the proposed merger between Internorth and Houston Natural Gas is the latest example. And, if the experience of railroads, trucking, banking and other deregulated industries is any indication, we will see more mergers as companies seek to reduce costs, improve market position or gain better access to low-cost reserves. Oil companies could do the same thing by swapping refinery capacity—selling to competitors in one area and buying from them in an other—improving capacity utilization while eliminating inefficient refineries.

LEVERAGING MANAGEMENT SKILLS

Companies with large cash flows may not find sufficiently profitable investments in their base businesses. They can then accept lower returns, increase dividends, strengthen their balance sheets (which makes them more vulnerable to a takeover) or acquire other businesses. The industry's track record in the latter area has been relatively poor. But Shell, for one, acquired Belridge and used its heavy-oil extraction technology to increase production by 120 percent.

BUYING BACK STOCK

Management always has the option of purchasing its stock. This is sometimes criticized as a public admission that existing management cannot find sufficiently profitable investments—an invitation, in effect, to raiders. But by avoiding investment in low-return projects, companies may improve their ability to capitalize on better investments down the road. They are simply moving in and out of equity with greater flexibility and at the same time paying dividends to stockholders in a more tax-advantaged way. Exxon raised its stock price to an all-time high recently through a large repurchase program.

Some will argue that even if all these actions are taken—and taken aggressively—there's no assurance that a company will become acquisition-proof. There may be no defense against what Martin Lipton called a "two-tier, front-end-loaded, bootstrapped, bust-up, junk-bond takeover." But these measures at least address the task that poison pill schemes do not and that will ultimately protect these companies: Getting their stock prices in line with their underlying value.

Right now this disparity between price and value exists because management has not responded aggressively to the changes in its industry. Management has to do what executives in banking, airlines, steel and other overbuilt industries have done when faced with overcapacity—compete and consolidate.

Ultimately, the issue is not whether the energy industry will be restructured. It will. Rather, the question is whether the restructuring will be done by existing management or by outsiders. Arco and others have helped answer it.

[From the Wall Street Journal, May 1, 1985]

TAKEOVER THREATS DON'T CRIMP LONG-TERM PLANNING

(By Gregg A. Jarrell and Kenneth Lehn)

Critics of hostile tender offers argue that such threats are inducing corporate managers to defer research and development and adopt a variety of defensive tactics ranging from "golden parachutes" to anti-takeover charter amendments. If this were the case, one would expect to find evidence that managers are maximizing short-term earnings at the expense of long-term projects, such as research and development. But a study we conducted as economists at the Security and Exchange Commission indicates precisely the opposite.

Critics of hostile takeovers have argued that these defensive actions and the increasing neglect of long-term projects are visible symptoms of a serious economic problem. Their central point is that hostile takeovers result largely from undervalued equity of the takeover target. This fundamental problem is attributed to large holdings of institutional investors in most publicly held corporations. These professional managers of billion-dollar portfolios operate in an intensely competitive environment. Their focus on short-term earnings reports, the argument goes, is a natural consequence of the pressure on them for short-term performance.

This points to a troublesome side effect. The contention is that a capital market dominated by competitive fund managers causes equity prices to favor short-term earnings reports disproportionately to long-term prospects, that the shares of firms with significant long-term programs sell at lower prices than those of comparable companies that maximize their immediate earnings, and that this environment creates openings for hostile takeovers.

This scenario of the causes and consequences of hostile takeovers has been widely publicized. Three articles in The Wall Street Journal in the past few months by authors with outstanding credentials (Martin Lipton, Felix Rohatyn and Peter Drucker) have advanced these arguments. A task force of the Business Roundtable and several private economists have advanced this theory in congressional hearings. The theory has also been the centerpiece of several recent articles on the problem of hostile takeovers in Business Week, Forbes and the New York Times. Key congress-

men have expressed support for the theory in hearings, and several anti-takeover bills have been proposed in response to this alleged problem.

However, this theory is based on very shaky empirical evidence. In fact, no advocates have provided supporting facts. They have relied instead on the "reasonableness" of this argument, and anecdotes. This neglect is quite surprising because of the economic sophistication of the proponents and because the theory has many direct empirical implications that can be tested with readily available data.

The SEC's Office of Chief Economist conducted a study of the relationship between institutional ownership of public companies and their R&D expenditures. Specifically, data were collected on 324 companies representing a cross-section of 19 R&D intensive industries, including aerospace, drugs, oil, timber, steel, semiconductors and telecommunications. For the years 1980–1983, measurements were made of the percentage of common equity held by institutions and the ratio of such companies' R&D expenditures to their total revenues.

The aggregate data reveal that as average institutional ownership has increased (from 30% in 1980 to 38% in 1983), so has the average R&D-to-revenue ratio (from 3.38% in 1980 to 4.03% in 1983). Thus, there is no evidence that the increasing institutional ownership has induced companies to curtail their R&D programs.

For each company, the relationship between the 1980–1983 change in institutional ownership and the 1980–1983 change in R&D-to-revenue ratio was closely examined. The purpose was to test the theory that rising institutional ownership causes companies to curtail their R&D expenditures. The facts show the opposite to be true. Apparently, institutional fund managers show a noticeable preference for firms with increasing R&D expenditures.

The study also examined the 217 firms that were takeover targets between 1981–1984 in an effort to isolate any patterns between institutional ownership and R&D expenditures for actual targets. First, 160 of these target companies reported that their R&D expenditures were "not material." For the remaining 57 firms, the data show that over the four years preceding their takeover, they had R&D-to-revenue ratios (0.76%) only half as large as the average for the other firms in their respective industries (1.53%). These data show that the target firms of the 1980s are characterized by very low R&D expenditures. Again, this fact contradicts the view that investment in long-term projects such as R&D makes firms vulnerable to takeovers.

The ownership structure of these 1981–1984 takeover targets was also examined to see if institutional ownership in these firms was unusually large. Ownership data were available for 177 target firms. Contrary to the prediction of the theory, the percentage of equity held by institutional investors in target firms (19.3%) was significantly lower than the corresponding average percentage for non-target firms in the same industry (33.7%). These data strongly suggest that institutional ownership per se does not fuel takeovers.

The proponents of the theory have asserted that stock prices decline in response to increasing R&D expenditures. This is another direct implication of the theory, and it too had not been systematically tested for validity. Our study examined the net-of-market stock price reaction to 62 Wall Street Journal announcements between 1973–1983 that firms were embarking on new R&D projects. These tests show that, on average, the stock prices of these firms increased (1% to 2%) in the period immediately following the publication of these stories. Again, this direct implication of the theory is refuted by the data.

Although these data refute the theory, we do not expect them to silence the critics of hostile tender offers. The dramatic human consequences of hostile tender offers give rise to claims and counterclaims about their economic and social desirability. However, policy makers should insist on empirical evidence, rather than rhetoric. Isolated anecdotes can be found to support any theory, and therefore prove none. Empirical evidence offers policy makers the best hope for intelligent decisions.

[From the New Republic, March 25, 1985]

PRODUCTIVE PREDATORS

It is almost 50 years since a lawyer named Adolph A. Berle and an economist named Gardiner C. Means published "The Modern Corporation and Private Property," a book that Stuart Chase in THE NEW REPUBLIC called "epoch-shattering." The authors demonstrated that economic power in America was being concentrated in the hands of fewer and fewer corporations. They also showed that this corporate power was no longer being wielded by the stockholders but instead by professional managers. In the ideology-laden 1930s, their first claim was easily accepted, even by

those who thought it epoch-shattering, as just some additional evidence that monopoly was the inevitable destiny of capitalism. The second proposition was somewhat harder to take, for its corollary was the end of the cherished idea taken from Marx of a capitalist "ruling class."

But as time went on, the fate of the two hypotheses was reversed. With the rise of new companies and whole new industries, concentration seemed to loosen and economic power to become more dispersed, while the managers were finally and unquestionably in the corporate saddle. (Very few Fortune 500 corporations have a discreet ownership group, let alone an owning family. Old families like the Rockefellers and the Mellons are still enormously rich, but they actually control little of industrial significance. The same fate probably awaits the families of more recent industrial geniuses.)

For a long time, this development was thought quite satisfactory. It appeared to cut the rapacious class of coupon clippers down to size while enhancing the sway of professionals whose conception of self-interest was thought broad enough to include some notions of communal good. Of course, even when Berle and Means wrote, the shareholder base of American corporations was quite wide. What with "people's capitalism" and mutual funds and pension funds and IRAs and Keoghs, it has become far wider still. In fact, this wide diffusion of stock ownership is what made the alienation of property rights and property prerogatives from the shareholders possible in the first place. The managers' power was based on the powerlessness of the owners. And so how have the managers behaved?

Berle and Means thought they might become plunderers in their own right, and some of them have. Greedy and inept managers have been blamed, with some justice, for the deterioration of our heavy industry, the forfeiting of competitive advantages to the Japanese and other Asian competitors, and the short-sighted cupidity of our energy providers.

These days, though, we are asked to take pity on beleaguered corporate managers, as some of the more vulnerable and culpable of them find their jobs threatened by corporate takeovers. The attacks are made possible by the mechanism of proxy voting, which Berle and Means thought simply ritualistic, the symbolic annual acquiescence of passive ownership to the "power without property" (as Berle called it in a later book) of managerial elites.

The source of these attacks is a new class of big rich in our society who are able to deploy financial resources sufficient to wage war against managers hitherto protected by the inertia and submissiveness of the people and institutions holding their stock. The members of this new class are not the clubbable sorts corporate America is used to. They are mostly outsiders, cagey and secretive. Most of their money is new; in the case of the Texans a tiny bit older. The cover of Business Week March 4 depicts these raiders of corporations as masked bandits. The March 4 Time cover shows T. Boone Pickens, Mesa Petroleum's ardent if somewhat indiscriminate pursuer of what he considers undervalued corporate properties, as a sly card shark. The March 11 Forbes cover is a parody of Eduard Munch's horrific painting "The Scream," with a headline lamenting, "Why is no one safe?" ("Predators emerged from under rocks and began to prey on healthy businesses. Is there no stopping them? Will they devour us all?")

The preying was going on for a long time before the Carl Icahns and Boone Pickenses came on the scene, but back then it was one huge corporation devouring another. This provoked interest but little outrage, except from the left. It is only with the dramatic appearance of the private raider that the takeover game suddenly has come to be viewed by the business world itself not as a spectator sport but as a morality play.

The script of this play miscasts both villains and victims. The putative victim, the traditional corporate leadership, has in truth made itself insecure by treating the stockholders so contemptuously. The managerial class has increasingly appropriated corporate assets as if those assets had no real owners, as if those assets did not pay its exorbitant salaries, and as if in the end managers were responsible to no one.

The great grievance against the raiders is that they force management to focus on short-term performance in order to keep share prices up and ward off takeovers. Managers are happy enough to claim bonuses based on short-term performance when it's positive. But more fundamentally, this notion that the stockholders don't really know what's good for them—and a high share price isn't it—is exactly the attitude that has given corporate raiders the opportunity they need.

No one need pretend that the corporate raiders are animated by benevolent motives to argue that their impact will be mostly salutary. Where smugness and inattention ruled, there will now be concern and even some nervousness. Why shouldn't custodians of hundreds of millions or billions of dollars of other people's invested

money, their savings, be a little nervous? Our system only works if it delivers a fair return on owners' capital, in dividends and in appreciated value. If a raider offers significantly more than the present market price for a corporation's shares, that usually means that he believes its assets are not mobilized efficiently, and he is willing to stake a good deal of money to prove it. Typically a management may be holding on to unprofitable divisions, which others might run more profitably, because of sheer inattention or unwillingness to admit failure.

In the Phillips takeover, the raider's offer has now obliged management as a counteroffer to reimburse its stockholders for their patience. Of course, Phillips will have to shed some of its properties to do that and become a smaller company. So what? The shareholders already have won a big victory. This would not have happened if the vast army of owners had not rebuffed Phillips's first chintzy response to the raiders. Crucial to this rebuff was the decision of some big institutional holders and of the pension funds of several state governments, including New York and California, to team up with both the adventurous raider and the small investor in saying to management, "Enough." This is likely to be a precedent. If it encourages more raids against self-satisfied managements, good. Phillips management now concedes that the company will be stronger and more disciplined as a result of the takeover struggle.

Targeted and potentially targeted managements have behaved shamelessly and frantically. The first tactic is to engage some high-priced legal and banking talent to hang some garlic around the corporation's neck to ward off the evil spirit. Next the managers provide themselves with "golden parachutes," in case their maneuvers fail.

Once these chores are done, managers really go to work. To safeguard their jobs, they trash their companies by acquiring anything that will make them unattractive and unpalatable to suitors. You can't imagine the junk with which corporate managements encumber themselves and their shareholders in order to ward off a raider. There is now a Wall Street specialty in placing unpromising but expensive assets with already burdened corporations whose managements suddenly want even more debt and even less cash flow. The courts have been no protection here; they will not second-guess a "business judgment."

Some raiders have been content to lose the big prize if they get paid off in what is now called greenmail. They cry all the way to the bank, and leave the ordinary stockholders more exposed and less well-off than before. This could be prevented by a small change in the law that would forbid management from paying off any shareholder or group at a premium above market without offering the same deal to everyone else.

When management receives an offer from a bidder, its proper responsibility is to go out and see if someone else out there is willing to bid more. Don't be surprised, then, if someone like Boone Pickens tries to start a populist prairie fire for some political guarantees of the long-abused rights of that big bloc of voters, the 40 million Americans who buy, sell, and own stock. It's certainly not a cause that ranks with the needs of the hungry, but it could sure muster great middle-class clout. No prominent Democratic politician has grasped this as a worthwhile issue. After more than half a century of virtually unrestrained managerial dominion over corporate life, it's time to reunite the owners of equities with some of their rights.

COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC, June 5, 1985.

Mr. G. CHRIS ANDERSEN,
Managing Director, Drexel, Burnham & Lambert,
New York, NY.

DEAR MR. ANDERSEN: Thank you for appearing as a witness at the Subcommittee's hearing on mergers and acquisitions. Your experience and expertise provided the Subcommittee with much valuable analysis and information. For the purpose of completing the Subcommittee's hearing record, I have enclosed a series of additional questions for your response.

I would appreciate your review and response to my office by June 15, 1985. If you have any questions, please contact Bill Cunningham of the Subcommittee staff at 225-5522.

Sincerely yours,

J.J. PICKLE,
Chairman, Subcommittee on Oversight.

Enclosures.

1. How would you define "high yield bonds" or what others may refer to as "junk" bonds? What are these bonds' characteristics? How did they come to be referred to as "junk" bonds?
2. How many such bonds have been issued to date? What amount of bonds are used to raise capital? What amount of bonds are used to finance mergers?
3. What recent large merger deals have used this type of bond financing?
4. Some claim that these bonds have characteristics that more closely resemble equity than debt. Do you agree?
5. How important is the interest deduction to use of these bonds? Would the mergers financed by Drexel, Burnham & Lambert still be feasible if the interest deduction was disallowed?
6. How do you calculate the appropriate amount of "commitment fee" to charge for high yield bonds used in mergers? Are "commitment fees" charged in all high yield bond transactions or just in merger situations?
7. Does Drexel, Burnham & Lambert have a "rule of thumb" or guidelines on the proper debt/equity ratio for companies? If so, please describe?
8. During your statement before the Subcommittee on Oversight, you described what and whose assets served as security for "high yield" or "junk bonds" used in acquisitions. You mentioned that factors such as cash flow and the ability to pay are important. Please describe how such financing is structured and from where security for the financing comes.

DREXEL BURNHAM LAMBERT, INC.,
New York, NY, July 26, 1985.

Hon. J.J. PICKLE,
Cannon House Office Building,
House of Representatives, Washington, DC.

DEAR CONGRESSMAN PICKLE: I have enclosed under cover of this letter the responses to the questions you raised by letter dated June 5, 1985 for submission in the record for the hearing held by the Subcommittee on Oversight on April 2, 1985 on mergers and acquisitions. Drexel Burnham is happy to be of assistance in providing information in this area. If there is any additional information you would like, please do not hesitate to let us know.

Sincerely,

G. CHRIS ANDERSEN, *Managing Director.*

Enclosure.

RESPONSES OF DREXEL BURNHAM LAMBERT, INC.

1. High yield bonds are corporate bonds which are rated below "investment grade" by Moody's or by Standard and Poor's, or which are unrated (i.e., they have been categorized BB+ or below). High yield bonds may be publicly traded or held privately. Insurance companies such as Prudential and Aetna have made such investments in unrated corporate bonds for many years. High yield bonds fall into two categories: (i) those that were rated investment grade when issued but which were downgraded and (ii) those that were rated below BBB or not rated when issued. The former category refers to corporations that have suffered business downturns and no longer qualify for the top ratings under the rating agencies' criteria. The term "junk" bond was coined to reflect such fallen fortunes. The latter category refers to everything else—issues by new companies, emerging growth companies and small to mid-sized companies only because they receive the same rating category designations (i.e., BB+ or below). Because the rating agencies typically emphasize size and historical record, these companies cannot qualify for an investment grade rating even though they may have a strong profitability outlook and excellent management capability. To put the term "junk" bond in perspective, one should be aware that out of approximately 19,000 publicly traded companies with over $25 million in assets only about 625 are rated investment grade.

With respect to the characteristics of high yield bonds, these bonds are offerings of debt securities by all but the relatively few companies whose securities are rated investment grade. Thus, while the particular issues vary greatly, they share the characteristics of other securities offerings: restrictive covenants on activities by the issuer, representations and warranties by the issuer, substantial analysis and due diligence by the underwriter concerning the creditworthiness of the issuer, and full financial disclosure on the part of the issuer. In addition, high yield bonds have a

highly liquid secondary trading market. Major market-makers in high yield bonds besides Drexel include Salomon Brothers, Merrill Lynch, First Boston, Morgan Stanley and Shearson Lehman Brothers.

These bonds, as their name implies, generally offer higher rates of return than investment grade securities. This higher rate of return, when combined with a diversified portfolio of high yield securities, produces favorable risk/reward characteristics. On an annual basis, a diversified portfolio of high yield bonds can earn approximately 3.5 to 5.0 percentage points above U.S. Treasury securities and AAA-rated corporate bonds and approximately 2.5 to 3.5 percentage points above mortgage-backed securities. Certain studies have shown that the default rate on high yield bonds is not inordinately high and that even after accounting for defaults, investors gained, on a weighted average annual basis, 3.25 percentage points above U.S. Treasuries.

2. The amount of public high yield straight debt currently outstanding is approximately $60 billion (representing $48 billion of issues by industrial and financial corporations and $11 billion by utilities), up from approximately $25 billion at the end of 1976. High yield bonds accounted for over $14 billion of public underwritings in 1984, or approximately 22% of all corporate bond underwritings during the year. Since all straight corporate debt outstanding as of the end of 1984 totaled approximately $425 billion, the high yield segment represents approximately 14% of the total corporate bond market. When all high yield securities are included (preferred stock, convertible bonds, etc.), the total high yield market is estimated to be about $100 billion.

High yield bonds offer emerging growth companies an alternative to traditional bank loans as a vehicle for raising capital. The overwhelming majority of these bonds are used for purposes unrelated to merger activities, including, for example, expansion of operations, retirement of bank debt, and day to day operations. By comparison, the percentage of high yield debt used in connection with mergers is relatively small. Of the approximately $14 billion of new high yield debt publicly issued in 1984, Drexel estimates that approximately 12% was issued in acquisition or leveraged buyout transactions. Of this amount, only a small number (perhaps 2% of the total issued in 1984) was issued in connection with the financing of unsolicited acquisitions.

3. Recent acquisition activities that have used high yield bond financing include the following: (1) Acquisition by Coastal Corp. of American Natural Resources ($600 million in total issued). (2) Acquisition by Triangle Industries of National Can ($365 million in total issued). (3) Acquisition by Farley Metals of Northwest Industries ($482.5 million in total issued). (4) Leveraged buyout by management of ConAir ($180 million in total issued)

4. No. High yield bonds are debt rather than equity because they have a stated maturity date and either a fixed rate of interest or a stated variable rate of interest payable at regular intervals. Equity returns (through dividend payments or through stock splits, etc.) are contingent upon a corporation's financial returns and management's decision to declare a return. Failure to make payment on a bond will constitute a default and trigger a number of remedies, including acceleration of the maturity of the bond. In addition, the breach of covenants set forth in the bonds, including financial covenants, can trigger a default. There is no equivalent feature with equity investments. Finally, under state corporate law, high yield bonds issuances are treated as corporate debt rather than equity.

5. The interest deduction is, of course, important to all borrowers, whether borrowing from banks or the public and whether paying higher or lower rates of interest. The availability of an interest deduction affects the cost of all types of financing. It is simply a matter of economics. Thus, whether mergers would still be feasible if the interest deduction were disallowed depends on a variety of factors; some would be feasible, some would not and some would be structured in an altered form. The real focus should not be on whether or not mergers would still be feasible in the absence of the interest deduction, but rather on the fact that the absence of the interest deduction to issuers of high yield debt would put companies that cannot qualify for an investment grade rating at a competitive disadvantage with those who can. It would also put borrowers at a disadvantage compared to those with large cash hoards. It would force borrowing directly from banks rather than from the public, with less flexibility and shorter maturities. It is not clear what would be solved by a focus on high yield bonds. Elimination of the interest deduction on high yield bonds singles out a particular type of financing for discriminatory treatment. If Congress wants to change the tax laws governing mergers and acquisitions, legislative action should be evenhanded. Why should medium size companies be disadvantaged relative to large ones?

There seems to be an underlying assumption that acquisitions are encouraged by the deductibility of interest compared with the nondeductibility of dividends. But that comparison is only part of the story. Consider that many of the purchasers of high yield bonds are corporations. Corporate holders pay full income tax on interest income. On the other hand, 85% of dividends received by corporations are exempt from tax. Therefore, there are many situations where stock would be preferred to debt by the financier. Adversely affecting the deduction for interest will, in our view, simply change the cast of characters in the merger markets to those preferring equity interests. The end result will not be the issuance of additional common stock but the issuance of preferred stock that receives priority over common stock.

Moreover, it is unlikely that any substantial tax revenue is lost to the government when portions of a corporation's capital structure shifts from equity to debt. Since corporations, on average, distribute only a relatively small portion of their income in dividends, there is no tax at the shareholder level on most corporate income. While interest is deductible, it is also income to the recipient each year. Therefore, as to the great bulk of corporate earnings, there is only one tax—either at the corporate or shareholder level. Even the amount paid in dividends is largely tax free to corporate shareholders, so in this case again, the total revenue effect of the use of debt versus equity may be largely neutral.

6. Typically institutional investors which commit to purchase high yield bonds in the context of a hostile acquisition get ¾ of 1% of the face amount of the bonds they have agreed to purchase as a commitment fee for agreeing to put up part of the financing. This fee usually covers a period of 60 days. If the funds have not been advanced within that period and the acquiror wants to extend the commitment, the institutional investors typically require another ¼ of 1% for each 30 day extension. Drexel also gets a commitment fee of ¼ of 1% for arranging the financing, although it typically does not get any fees if a commitment is extended.

Commitment fees are generally only paid in the unsolicited acquisition context. Because a commitment by an institutional investor takes a considerable amount of time and effort (and generally must proceed on a very tight time table), these investors are entitled to some recompense for their efforts and for tying up funds where actual funding is uncertain. As for the amount of the fee, it reflects the market's requirement to induce potential lenders to commit their funds to transactions with an uncertain outcome. These fees are similar in nature to the commitment fees that commercial banks charge for unused balances on a bank standby line of credit and those charged by insurance companies for "delayed takedown" private placements.

7. Drexel has no "rule of thumb" as to what is the proper debt/equity ratio a company should maintain. Rather, because each company possesses unique economic attributes—both positive and negative—the determination must be made on a case by case basis. In addition, each company has its own preference as to the amount of debt it considers appropriate. In making a determination as to the proper debt/equity ratio, however, Drexel considers certain basic economic criteria. These criteria, which are used by most investment banks, include:

(a) Stability of cash flow. The more stable the cash flows, the higher the leverage that can be tolerated before incurring unacceptable risk. Finance companies, for instance, typically are highly leveraged entities because the cash flow from their assets (usually receivables) is highly predictable.

(b) Market leadership and confidence in management. The predictability of cash flows is directly related to the level of market leadership. Market leadership provides management with more control over the company's destiny. Moreover, the caliber of management increases the likelihood of successful operations.

(c) Technological stability. Technological stability implies that capital expenditure programs, the ultimate payoff of which is both uncertain and well into the future, are minimized. In addition, the risk of technological obsolescence and loss of market leadership is also minimized. These factors, in turn, lead to stability and predictability of future cash flows and thus, to the ability to service debt.

(d) Industry outlook and position of the company in the industry. The brighter the outlook of the industry and the stronger the competitive position of the company in its market, the more business downturns and risks are minimized. As noted above, these factors in turn, lead to stability and predictability of future cash flows and to the ability to service debt.

8. Structuring an acquisition financing involves many interrelated steps and determinations. First, a determination must be made as to the amount of capital the acquiror requires for the transaction. The most important consideration is of course the cash flow of the surviving merged entity and its ability to service its debt. Financings are typically structured so that anticipated cash flows can service the debt and operate the company without resorting to the sale of assets. If cash flows will

not be realized for some period of time, additional capital may be appropriate to cover the debt service, dividends and expenses of operations until such time. In addition, the assets of the company must be evaluated to determine whether they can serve as collateral. Finally the proposed equity structure of the company after acquisition plays a part in determining the terms of any debt financing.

Once the level of debt and equity is established, a determination is made how this amount should be raised—i.e. what combination of securities and maturities, etc. is appropriate. Bank debt may offer lower interest rates but require more immediate repayment terms than funded debt. Conversely, long term bond financing may subject the issuer to a higher interest rate but allow it to tailor the financing more closely to its needs and the interests of potential investors. For example, a package can be put together including bonds with different levels of seniority and different levels of security, convertible bonds and bonds allowing deferral of interest for a specified period, etc. This allows both investors who are willing to take a smaller return for less risk and those who desire greater returns through greater risk and/or equity participation to invest.

The security for the high yield bonds comes from several sources, the most important of which is the value of the issuer as a going concern. As previously noted, financings are structured so that cash flow can cover the debt service, thereby making other security less important. Second, equity investments (either common or preferred stock) in the issuer serve as added protection as does any level of debt which is junior to any other specific issue. The cash contribution put up by the equity holders serve as a backup for cash flow and represent assets of the company. Since bonds are general debt obligations of the issuer, equity holders are generally placed behind other creditors, including investors in the issuer's high yield bonds, and may not receive any distributions until all creditors have been satisfied within the framework of any specific additional covenants of the debt. For example, the bond may limit the payment of dividends by the acquired company to a specified percentage of earnings, allow acceleration of the maturity of the bond if equity of the acquired company falls below a certain level or restrict the return equity holders can receive on their investment in the acquired company during the period the bond is outstanding. Finally, any assets of the acquired company which are not otherwise encumbered can serve as security for bonds.

Chairman PICKLE. The subcommittee will come to order again.

Our second panel consists of Mr. Fred Hartley, chairman and president of Union Oil of California.

Mr. Hartley, which one are you?

The other gentleman is Mr. William C. Douce, who is the chairman of the board and chief executive officer of the Phillips Petroleum Co.

Mr. Douce, that is you in the center, I presume.

Mr. DOUCE. Right.

Chairman PICKLE. Would you identify the other individual at the table with you?

Mr. DOUCE. Yes, Chairman Pickle. The gentleman with me is vice president and general tax counsel of Phillips Petroleum Co.

Chairman PICKLE. All right. We are glad to have all of you.

Mr. Hartley, would you like to proceed first?

I apologize to you for the delay, but I think you all know that we regret it. We want to recognize you for whatever time you want to present.

If you want to give your statement in its entirety or by summary, then you are welcome to do it the way you wish.

Mr. JONES. Mr. Chairman?

Chairman PICKLE. Mr. Jones?

First Mr. Hartley, if you would suspend for just a minute, I want to recognize Congressman Jones for a statement.

Mr. JONES. Mr. Chairman, what I would like to do, rather than testify today, is to submit a formal testimony as to the reasons why we have introduced this legislation.

I would say that, even after the last panel, I am convinced there is a public policy issue involved here that needs to be corrected.

What I would ask the chairman is, on the 16th, when you resume these hearings, if you would give me an opportunity to testify at that time.

Chairman PICKLE. You will be recognized on the 16th. In the meantime, as I understand it, you are submitting a statement for the record at this point.

[The statement of Mr. Jones follows:]

STATEMENT OF HON. JAMES R. JONES, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

Mr. Chairmen, I am very pleased to be here today to discuss some of the more significant Federal income tax consequences affecting acquisitions and mergers of corporations

When Chairman Rostenkowski announced that your subcommittees would hold the hearing, he stated, "With increased Congressional concern over the number and content of recent acquisitions and mergers, it is important that we have a clear understanding of the importance and role of various tax provisions in corporate mergers and acquisition decisions. The large number of recent mergers and acquisitions," he stated, "raise national issues that deserve thoughtful analysis."

You and Chairman Rostenkowski are to be commended for your role in bringing these issues before the American public.

You know that I share this concern. Over a month ago, I introduced legislation which addresses what I consider the most significant tax favors derived by takeover participants—those provisions which unfairly bias corporate takeovers. There are many other provisions in the tax code which influence merger and acquisition decisions. I am pleased your subcommittees will be examining these code sections in a reflective and reasoned manner, and I look forward to working with you on this long-term project.

My comments today, rather than focusing on these broader provisions, however, will be limited to the specific purpose of my legislation, H.R. 1100. My bill is something that needs our immediate attention and action.

I know that you will hear today from a number of investment and tax professionals who are sophisticated in the ways of Wall Street. They probably do not understand how confused and unsettled millions of lay people across the country are by the recent wave of takeovers (although they fully comprehend the millions of dollars being pocketed by a handful of "money managers").

It is of no concern to them that, suddenly, the business pages are as noisy with 15 round knockouts as is the sports section. The world of business now appears to be a jungle ruled by laws that even Darwin would find harsh. To the public, it appears that a pack of wolves is loose, bent on gobbling up whatever unsuspecting prey they can pilfer.

If members from both parties in Congress seem to be upset and confused as well, let me warn our investment industry friends, that may be because Congress is a representative body: it reflects what people generally are feeling. We are concerned because our constituents are concerned.

Before I discuss my legislation, let me begin by making a few observations:

Recently, in testimony to Congress, one well-known corporate raider told us that economic distortions caused by legislated barriers on U.S. capital markets are not in the public interest.

He is absolutely right.

The President's 1985 Economic Report, in a chapter on mergers, states that they improve efficiency, transfer scarce resources to higher-valued uses, and stimulate effective corporate management.

The President's men are correct.

Others claim acquisitions are a legitimate aspect of free market resource allocation, a natural process in a healthy economy.

They are right.

Our free market most efficiently functions when acquisitions discipline the allocation of our capital resources. Investors and company managers must have the ability to merge capital. Shareholder rights to replace entrenched, lackluster management must be protected.

These are principles in which I believe.

I also believe, along with a number of intelligent and patriotic people, that the current spate of liquidation takeovers is a dangerous economic harbinger. I believe that:

Most corporation raiders have little in mind but to make a fast buck; to seize their prey, dismember them and pick them clean, and then to move on. Their real motive is not better management; it's big money.

The rash of hostile takeover attempts has created an epidemic of takeover fear, meaning that we are failing to do what is necessary to build up our companies for the long run.

The recent takeover battles have created a mountainous slag-heap of corporate debt that threatens to crush the companies involved.

Simply put, I strongly believe in the free market system. It is a system that operates best unfettered by government interference or regulation. Having said that, I must also say, I believe that abusive corporate raiders, wanting nothing more than to pilfer strongly managed corporations, are a violation of the free market principle if the federal government is sitting back as a silent partner in the raid.

My premise is that the tax code should be neutral with respect to the decision of whether or not to merge.

I am not claiming that all hostile takeovers are bad for the economy, and therefore should be restricted. Nevertheless, let me discuss some of the misstatements you will hear today from those handful of individuals who are profiting by breakup liquidation takeovers.

First, it is alleged that the flurry of mergers today is little different than the wave of mergers spanning the late 1960s and 1970s. It is true the data show that recent merger activity, as measured by the number of reported transactions, has been at a rate less than half that reported in the 1960s. What belies the data, however, is the fact that of the 100 largest merger transactions recorded through year-end 1983, measured by the dollar volume, 65 of the 100 occurred between 1981 and 1983, 24 occurred between 1979 and 1981. Only 11 percent occurred prior to 1979. That is like raising the stakes at the crap table from $50 to $5,000 per roll.

Second, some corporate raiders have seized upon the populist folklore that they are Robin Hood bearing stock premiums for the small investor. Altruists they are not.

For example, you may have seen a Forbes Magazine study released two weeks ago. Forbes studied 39 cases in which companies defeated hostile tender offers and remained independent. Which course, the study asked, would have gained the most for the stockholders: selling out to the corporate raiders and reinvesting the proceeds in the Standard and Poor 500? Or holding the company's stock through the end of 1984? In 17 cases, the unsold company's stock outperformed the index, sometimes by 3 or 4 to one. So, according to Forbes, in almost half the cases, "money managers would have maximized their profits by holding shares rather than tending them." This suggests that the results of the takeover wave are mixed at best.

Have corporate raiders flowed through to their shareholders the profits made from attempted takeovers? Let me suggest they have not. One witness we will hear from today has made nearly one billion dollars between 1982 and April, 1985, from attempted takeovers, all of which have been unsuccessful. How much of that one billion dollars has been returned to his shareholders? In 1984, this man paid through his corporation a shareholder dividend of approximately $13 million. This is the same year in which he earned over $750 million on the unsuccessful takeover of Gulf Oil Company.

I might add that this is the same year this man was paid compensation and bonuses totalling $28 million. In other words, his personal salary and bonuses were more than double the entire dividend his company paid to its shareholders.

Also, let me comment on the Council of Economic Advisers and the Office of Management and Budget's argument that all takeovers are good because they move assets of the target into the hands of more efficient management. They also argue that takeovers do not recklessly increase the debt burden of target corporations.

Breakup liquidation takeovers by profiteers do not move assets into the hands of more efficient management. They do one thing: move assets to individuals who reap profits by terminating the allocation of corporate cash flow into research and development and capital improvements. They move assets into hands which use them to do nothing but pay off corporate debt.

One leading tax expert put it this way: "One can analogize the situation to a farmer who does not rotate his crops, does not periodically let his land lie fallow, does not fertilize his land and does not protect his land by planting cover and creating windbreaks. In the early years he will maximize his return from the land. It is a

very profitable short-term use. But invariably it leads to a dust bowl and economic disaster.

"We have entered the era of the junk bond takeover. Day after day the takeover entrepreneurs are maximizing their returns at the expense of future generations that will not benefit from the research and development and capital investments that takeover entrepreneurs are forcing business to forego."

I guess I should not be surprised that this Administration is unconcerned that we are recklessly mortgaging away our future. Their policy of favoring these liquidation takeovers is a policy that favors the present, rather than the future. It is consistent that this policy would come from an Administration that favors huge deficits. These are deficits which benefit us at the expense of our children.

In 1984, this country experienced a net loss of $90 billion in equity capital, and replaced it with corporate balance sheets filled with red ink. The $90 billion represents the debt incurred in takeovers, stock repurchases, and leveraged buyouts.

These facts suggest to me that there is a danger, in some liquidation takeover activity, of abusing the free market process—and creating undesirable future burdens for shareholders and the national economy.

When companies start worrying about sharks, the first thing they forget is tomorrow. This myopic vision of corporate planning will serve only to erode our already weak position in international markets. Our Japanese trading partners must be relishing the thought that corporate America is cutting long-term research and development in order to compete to make quarterly earnings reports look better.

Use of high-yield, unrated securities to finance merger activity led Federal Reserve Chairman Paul Volcker to state in a recent letter to the Committee on Banking, Finance and Urban Affairs, "I, like you, have concerns about the potential risks associated with mergers and takeovers when these transactions involve unusual amounts of leveraging. I hope that investors outside the banking community will apply caution in appraising various types of financial arrangements such as low-rated "junk bonds" by companies in takeovers. The fact that junk bonds carry a low credit rating indeed suggests that investors view such issues as high risk, or speculative, investments."

This is the reason I am testifying to you today. My message is very simple. It is time the lawmakers seriously considered how to stem the federal government's participation in these questionable, even damaging, activities. Regrettably, most of the Congressional effort to date has focused on methods to stop combinations of big oil companies and to outlaw all hostile tender offers. Banning mergers through moratoria legislation will only result in lower corporate equity. It violates the norms of free enterprise.

Stopgap proposals will not cure the malady that ails corporate America. What ails corporate America is that we allow the federal government to subsidize these bootstrap liquidations of U.S. companies. Our subsidies are without economic purpose. Therefore, we must begin by rethinking most of the tax rules that apply to corporate takeovers.

My own judgment is that the best position the government can take toward such mergers is a hands-off position: one of neutrality. In fact, however, the federal government is often a silent partner in liquidation takeover bids because corporate raiders can count on considerable tax advantages which accompany their activities.

I don't think the government should be that kind of silent partner, and so two months ago I introduced legislation which challenges the tax savings now enjoyed by participants in takeovers.

Already over 65 of my colleagues in the House have joined me in cosponsoring this bill, including Mr. Matsui, Mr. Stark, Mr. Dorgan, Mr. Gibbons, Mr. Pease and Mr. Jenkins of our committee.

My legislation would accomplish two things:

First, it would reduce the interest deduction that is now allowed for indebtedness incurred in corporate acquisition. The current tax code already restricts deductions for this purpose; my bill would increase this restriction. It would do this by denying the interest deduction when a takeover is funded by junior obligation debt—known in the trade as "junk bonds." The legislation is not an attack on junk bonds per se; it simply says: "When they are used for acquisitions, they won't be considered debt that qualifies for an interest deduction."

One manager of a big junk bond portfolio likens the management of junk bonds to the business of insuring risky drunk drivers. Why? Let me briefly give you some highlights.

From 1979 to 1984, the average junk bond fund gained 78.91 percent in value, barely better than A-rated corporate bond funds, which gained 72.95 percent. Latecomers, according to a recent article in the Wall Street Journal, haven't fared even

that well. Last year, junk bond funds were up only 7.23 percent, while A-rated bond funds gained 12.9 percent. And the risks, the Journal concluded, are rising.

Losses to investors from bankruptcies in 1984 were more than double the combined losses from 1976 to 1983. Yet, the pressure continues to grow. Almost 40 percent of the existing junk bonds were brought to market in the last three years, a period of strong economic growth and declining interest rates. Come the next recession, Businessweek quotes one skeptic, saying, "There will be Hell to pay."

Second, my legislation would end the universally condemned practice of greenmail. Greenmail, as you know, is the speculator's version of blackmail. It occurs when a speculator buys up a large block of shares in a publicly-traded company, with no purpose beyond threatening the corporation into buying back the shares at a premium. The raider's offer is usually secured only with the junk bonds.

What is the purpose of my legislation? It is simple: To get the government out of the business of underwriting liquidation takeover activity without hindering the legitimate movements of capital that are necessary in our free market system.

I do not think that it is productive to have the federal government regulate mergers; in fact, I think it is destructive. But, on the other hand, we must get the federal government out of the business of underwriting corporate takeovers. My bill would accomplish this, using a bit of modest leverage through the tax code.

Mr. Chairmen, our free enterprise system has proven itself to be the system most capable of lifting the greatest number of people out of poverty, of building a great nation. But raw, Darwinian speculation such as that committed by these corporate raiders is an aberration. It is alarmingly reminiscent of rampant, 1920s-style speculation, which plunged our nation into the deepest depression in its history.

While we should at all costs avoid interfering with our free market, we should also see to it that government does not encourage such irresponsible financial activities.

Chairman PICKLE. I will also say that on the 16th panel No. 4 will be a change somewhat. Two of the gentlemen, Mr. Ginsburg and Mr. Keilin will appear on the 16th rather than this afternoon since our time is running short. I have asked if Mr. McKee and Mr. Eugene Keilin will appear on panel No. 3. Is that agreeable? Has that been cleared?

Now, Mr. Hartley, would you proceed?

STATEMENT BY FRED L. HARTLEY, CHAIRMAN AND PRESIDENT, UNOCAL CORP. AND THE UNION OIL CO. OF CALIFORNIA

Mr. HARTLEY. Thank you, Mr. Chairman.

I thought perhaps, to gain a little bit of perspective here, I might just make a few remarks.

You are looking at a real live target company, Unocal, which is the parent corporation of Union Oil Co. of California.

We are a company which is valued somewhere between 8 and 10 times the worth of the company that Mr. Pickens operates, called Mesa Petroleum. They are the company which is challenging our management, my management. All of a sudden, and time and again, as he has talked about this afternoon, Mesa has knocked off various companies, putting them into tailspins, with results that we are all aware of. No doubt, he has the desire to do that same thing to Unocal.

Questions were raised about taxes, and I certainly agree with those gentlemen who raised those questions. Our worldwide tax payments in 1982 were $602 million; in 1983 they were $442 million; in 1984 they were $538 million.

In 1982 our State—all the States in the Union—tax payments were $50 million, our Federal was about $370 million. In 1983 our State payments were $47 million, our Federal was $253 million. In

1984 our State payments were $43 million and our Federal was $144 million.

I would convey with that information that we certainly try to do our share of carrying the load of providing money for our Government to meet all of its obligations.

Also, Mr. Chairman, I would like to set the record straight on a couple of points that Mr. Pickens made. They were quite obviously personal attacks on me, which comes as no surprise, because after we responded to his proposal that we delay our shareholder meeting from April 29 to June 28——

Chairman PICKLE. To what date?

Mr. HARTLEY. To June 28, which apparently was a more convenient date for Mr. Pickens—we indicated, no, we were going to carry on our tradition of holding our annual shareholders meeting as we should, without inconvenience to our shareholders, as scheduled. At that point he made a response to the press the next day and said, "Well, Mr. Hartley is hostile but he's always hostile."

Now in today's testimony he told you good people that Mr. Hartley runs around loose and exclusively on an airplane that he assigned a value to of $27 million. I believe that is the right number. He said the plane was used exclusively by Mr. Hartley, the CEO of Unocal and that I had a piano onboard.

Now it just so turns out that the airplane is about 13 years old. We obviously updated it, Mr. Chairman, for safety reasons and to live with the laws of the land on flying aircraft, but I think it stands on our books now at something less than $3 million. That's $24 million less than the number that some poor, unfortunate PR person on Mr. Pickens staff is going to be hearing about when they get the message.

Second, I am delighted to tell you that at one point there was a piano on the plane; it hasn't been on the plane for some, oh, 7 years. Very frankly, sir, I had the unfortunate requirement of a heart bypass. We are a friendly company. We have great employees, and all the pilots got together and threw some money into a pot and they bought a small electronic piano. They worked their heads off on their own time and they installed it. When I was brought out to the aircraft to come home from the Mayo Clinic and the hospital there, much to my surprise, they had done this very nice thing as a friendly gesture and a goodwill expression on their part for my early recovery and return to full duty.

I don't know that that would impress Mr. Pickens very much, because I am still here while he is doing what he thinks he wants to do to our company.

But the doctors did a good job and the Lord has been willing, and I look for quite a bit more time in order to solve my present problem.

He also made references to my not shaking hands with him. I have been trained in a little etiquette in my life, in manners and morals; and I think when you are talking to a lady and she is talking to you and asking some questions, that there is no reason to be interrupted by anybody, especially somebody like Mr. Pickens. So I did not extend my hand for the handshake.

There is nothing hostile about me in that regard; but, you know, when you really do think about it, there really isn't much reason for me to shake hands with Mr. Pickens. I will just let that pass.

Now you are here to hear a lot more than that kind of stuff, but I think that getting the flavor of what is going on in America is pretty important, because what is going on is unbelievable.

Chairman PICKLE. I do get the message that there is a hostile attitude prevalent, and I can understand.

Mr. HARTLEY. To become formal here, my name is Fred L. Hartley. I am chairman and president of the Unocal Corp. Unocal Corp. is the parent company of Union Oil Co. of California, one of the Nation's remaining major integrated oil companies.

You know, there were 15 of us. Five have already been murdered.

I appreciate the opportunity to be here to discuss tax and other aspects of mergers and takeovers. My written statement deals with these matters at some length.

To be helpful, I have prepared a summary statement in the interest of time, and also to give more opportunity for you and your associates to question me.

Let me first touch on the subject that we seem to quickly forget all about. Only a few years ago I faced committees in Congress that were demanding to know the cause of Unocal's gasoline lines and the reasons why we were not drilling more oilwells in the United States. Now I find myself faced with the opposite question—why does Unocal want to stay in the oil business? Why do we insist on spending money looking for oil in the United States or keep trying to develop alternative energy sources? Why, indeed? What short memories we have.

I would like to make it clear that I am not here to argue against friendly mergers and acquisitions. Such moves are an important and continuing element in the functioning of the free enterprise system and frequently make business sense and have overall advantages to the Nation.

Rather, I am here because corporate raiders and takeover artists are using the Tax Code and misusing the financial system to wreak havoc with one of the Nation's essential industries. Consider the following:

In 1980 there were 15 major integrated oil companies, most all with conservative debt burdens, competing with each other in onshore and offshore exploration—which of course provides funds to our Government through competitive bidding on offshore leases—in research and development, and in trying to meet America's energy needs.

But in less than 5 years, raiders have caused five to disappear as independent entities while four have taken on such large debt burdens that their competitive vigor and risk-taking ability must be placed in serious doubt.

Now Unocal is being "put into play," as they say on Wall Street, with the possibility of a takeover or a liquidation staring us in the face.

Mr. Chairman, I try not to get emotional about all this because I don't want to appear to be simply another businessman selfishly defending his job. I might add I am 68 years old and I could have

quit long ago, but I am not going to quit until this kind of nonsense is put to an end. I am going to make that additional contribution to my country.

Please believe me when I say I am not, but I am emotional, and for good reasons. What is going on is a serious national issue with serious consequences for our economy and our national security. Let me put it this way: If the Russians had somehow quietly managed to murder five of the Nation's leading oil companies and were stalking the rest, I am certain that Congress would be in an uproar demanding action. But murder it has been and murder it may be; and where is the congressional action?

Let me stress that Unocal has become a raider's target not because we are unsuccessful, but rather because we have been successful. We have been successful in finding oil at low cost. We have been more profitable than most of our competitors, and we have provided better returns to our shareholders.

Mr. Chairman, when success in the harnessing of the Nation's energy resources brings on the destructive results of takeovers, then something is seriously amiss in our Nation's financial and tax system.

It is important to understand that this raiding is not going on because Unocal and all other integrated oil companies somehow suddenly need to be restructured, as claimed by Mr. T. Boone Pickens in his testimony before another House committee on February 27 and elsewhere.

Carrying Mr. Pickens' line of reasoning to its extreme, we would end up with every large U.S. oil company either being merged, liquidated, or decapitalized; that is, forced into a massive conversion of equity to debt, as happened to the company led by my good friend alongside of me here, the Phillips Petroleum Co.

This is obviously an impossible result with impossible demands on the credit system. It is also a result that, even if partly achieved, would be severely damaging to the national economy and our Nation's energy security. It could also lead to a reconcentration of our oil industry, pushing us back to the monopoly days of the Standard Oil Trust, which, as you know, this great Congress took the position of doing something about way back in 1907. It is absolutely unbelievable to think that this Congress is sitting idly by while the monopoly is put back together again piece by piece.

Let me briefly discuss what I think is the cause of this raiding mania. I believe it is happening, first, because of the tax system which permits the deduction of interest on borrowed money used for successful, unsuccessful, or even threatened raiding; it favors debt over equity. It favors the so-called investor who loves debt over the businessman who believes in equity.

Second, this is happening because enormous amounts of money have become available for speculative short-term deals as a result of the move to deregulate financial institutions. Some of those institutions are now acting foolishly, buying high-risk debt with other people's money and hoping it will all work out—and, incidentally, they are borrowing against the stock of the target company in the case of the junk bond usage. I don't care what anybody says; that's the fact.

A recent Forbes article, "An Idea Whose Time Has Gone," discussed the phenomenon of federally backed savings and loan financing takeovers, greenmail and stock speculation. Rather than these same savings and loans institutions providing old-fashioned home loans—such as those I am sure many of you used to purchase your own home at interest rates that were affordable—they are trading in junk bonds.

Forbes commented, "that is potentially very lucrative but exceptionally risky, especially for savings and loans already in such weakened condition that they have very little capital left to lose." That statement is differentiating, gentlemen, between their capital structure and all of the loans they have on their books, which of course is the money they owe their depositors.

Clearly, our banks, savings and loans, and security firms should be concentrating on loans which create jobs and add to the Nation's real wealth, not on loans that benefit only speculators, takeover artists, and their lawyers.

Do they realize that a further major drop in world oil prices, coupled with an increase in high interest rates—these are not unlikely events—could throw many of these high-interest, low-security, junk loans into default, thus pushing banks and savings and loans to the brink of failure, forcing a new round of Federal bailouts?

I might add, of course, that these deposits in these institutions are foolishly guaranteed by this Government up to the total $100,000.

Third, with the emergence of junk financing bidders can borrow 100 percent of the cost of an acquisition in advance, with little or no security, on the promise that they will bust up the target to repay the loan. This is what enables raiders to threaten targets, including Unocal, many times their size.

Fourth, this is happening because of the emergence of a group of professional raiders, an industry of liquidators whose interest is not in the overall health of the economy nor in helping true shareholders but only in making quick-turn profits for themselves. And in the case of the oil industry, Mr. Pickens has somehow created a speculative frenzy that has convinced his camp followers—and I stress that "camp followers"—that there is easy money to be made in attacking oil companies—and to hell with tomorrow.

But this speculative binge, this chain letter, must eventually collapse, leaving wreckage of ruined companies, lost jobs, reduced U.S. oil production, failed banks and savings and loans, and Government bailouts, not to mention unemployment and empty buildings, in places like Pittsburgh where companies have been destroyed.

What is Congress' appropriate response to this raiding, restructuring mania?

I might say, Mr. Chairman, we are delighted that you are taking the initiative in holding these hearings to try to get this issue front and center, and hopefully as quickly as possible, because you may not just be looking at a target right now; you may be looking at the next guy to be murdered. We urge that Congress take action in these areas.

The most urgent need is for a quick moratorium on hostile takeovers—a sort of cooling-off period during which the Nation has a chance to pause and think about what is going on, the speculators

have a chance to realize that this chain letter can't go on forever, and Congress has a chance to make some needed changes in the Tax Code and possibly elsewhere.

H.R. 998, 1182, and S. 473 are bills that call for such a moratorium. I stress the moratorium because the clock is ticking; this kind of climate can bring about the destruction of a company.

Second, the Tax Code should be revised to end the raiders' tax subsidies; that is, the interest deduction on the loans used in hostile takeovers and the treatment of green mail, so-called expense payments, as if they were normal business expenses.

I might, Mr. Chairman, give you my definition of greenmail: You buy your stock for less, and you buy it secretly—which is the way it is done—and then push it to higher levels, hoping ultimately for a white knight or something like that to come along and push it even higher. No matter how you slice it, the difference between what you paid for it and what you get for it as a raider is greenmail, blackmail, Pickens mail—call it what you want.

Now as Edgar Bronfman, chairman of Seagrams, has said:

> If the interest and corporate takeover money borrowed specifically to buy the common stock of another corporation were not tax deductible, as it now is, such activity would be sharply curtailed. To the extent that it was not Federal tax revenue, it would be increased, and the average taxpayer would thus far not be as they are now, indirectly footing the bill for part of these corporate takeover games.

That is the end of the quote from Edgar Bronfman.

In addition to disallowing the interest deduction for takeover loans, we believe there should be special punitive taxes imposed on greenmail payments—that odious but often irresistible form of legal blackmail.

Further, all income from the raiders' stock transactions should be taxed at ordinary income tax rates, just like any other property business that a company finds itself in. I am sure you know that is the normal procedure when you buy and sell real estate properties as a business. As you develop land and sell it as a business, it is taxed on a normal tax basis. Since Mesa is a stock transaction company, they should pay the normal income tax rate.

H.R. 1100, sponsored by Congresman Jones of this committee, S. 286, S. 420, S. 476, S. 414, and S. 632 are bills that deal with some of these tax issues, but in our opinion insufficiently.

There is also a legislative need to correct the general rules of the takeover game, so that they would have, in the words of former SEC Commissioner Sommer, "a level playing field."

For example, pyramiding on margin or target asset values should not be permitted by Congress. We've got H.R. 1074, H.R. 1075, S. 631, and S. 706 as bills that deal with issues of this nature.

Mr. Pickens said he only borrowed on Mesa Petroleum's assets. His vice president of finance, Mr. Batchelder, recently stated that they will be able to buy more stock on margin with the shares of Unocal they already possess. That's a quotation from his vice president.

In addition to the above legislative action, I believe Congress has an appropriate oversight role in raising the merger-takeover and related issues with the proper Federal agencies, especially those that have regulatory responsibility for our financial system.

In plain words, don't let the participating banks and savings and loans get so greedy that they do themselves in.

Let me close with these two final observations:

First, we feel quite strongly that the Pickens approach to restructuring America's oil companies must be stopped for the simple reason that his idea is both wrong and bad for America. The beneficiaries of Pickens' actions are not America's energy consumers, America's security, or even the small shareholder, since many of these folks have been talked out of their shares by brokers during the raiding period in which our stock was and is purchased secretly.

The beneficiaries are, rather, only a handful of shareholders—and, of course, Mr. Pickens himself—through his board's generous recent action in voting him a $27 million bonus for work done over the last 3 years, but especially the moneys earned on the gain of stock value on the Gulf deal and the Phillips deal. That amount of money was more than twice the common share dividends paid in 1984 to Mesa's shareholders. I don't want to argue the $27 million, whether it is deferred or partially deferred or what; the fact is that the action was taken to put that money for use at Mr. Pickens' discretion in further raids that Mesa decides to participate in.

Recognizing the shares that Mr. Pickens now has on an approximate basis, he was paid in this bonus about $20 per share. His beloved shareowners got 20 cents in 1984. Mr. Pickens goes around the country and tells the world he is the small shareholders' friend. Unocal shareholders, please note.

Second and finally, we want to stress that Unocal does not view America's oil industry as a sunset industry, as Mr. Pickens does, but rather as a place of opportunity both for finding new resources, new sources of oil and gas, and for developing alternative energy sources.

Now these kinds of thoughts would never occur to Mr. Pickens because he is hardly in the oil business. His $75 million budget in 1984 compares to our $2.1 billion budget of reinvestment for purposes of enlarging the size of the pie for employees, consumers, and stockholders.

Independent studies of our oil-finding record show us to be among the industry's best. For example, a recent study by Arthur Andersen and Co. found that Unocal's U.S. finding cost per barrel of oil and gas—where gas is converted to an equivalent barrel of oil—was $6.82 a barrel for the period 1980 to 1983. This was the lowest of the 16 majors in the study.

Don't let anybody give you a figure as to what their finding costs for 1 single year are. The experts in the industry have concluded that about a 4-year time period to look at is about the only valid way you can really judge performance and get at the average cost of finding oil.

You'll be interested in knowing that Mesa's finding cost for the same period, by contrast, was reported to be, by Arthur Andersen—this report, by the way, gentlemen, only came out about 2 weeks ago—it was $14.82 per equivalent barrel.

Now I must admit, if I had that record, I would probably quit drilling wells and start drilling in Wall Street. He is now and has

been doing so because our society—the climate we have provided for that kind of action—has permitted it to take place.

Further, our leadership in geothermal energy and oil shale development shows us to be among the industry's most farsighted. Please let me assure you that, come the next energy crisis, Unocal expects to be in the front line in providing Americans with urgently needed petroleum products. Where, I might ask, will Mr. Pickens be at that time?

Mr. Chairman and members of the subcommittee, too many fine oil companies have already been destroyed or nearly so by Mr. Pickens and his ilk. Unocal will compete with anyone when the game isn't rigged. Your action can help unrig the takeover game and restore free enterprise balance to financial and business affairs.

I urge you to take the appropriate action immediately to protect your country and mine from further decay.

Thank you very much, gentlemen.

[The prepared statement follows:]

STATEMENT OF FRED L. HARTLEY, CHAIRMAN AND PRESIDENT, UNOCAL CORP. AND THE UNION OIL CO. OF CALIFORNIA

Mr. Chairman and subcommittee members: My name is Fred L. Hartley. I am chairman and president of Unocal Corporation. Unocal Corporation is the parent company of Union Oil Company of California, one of the Nation's remaining major integrated oil companies. I appreciate the opportunity to be here today to discuss tax and other aspects of mergers and acquisitions. For a variety of reasons, this hearing is most timely.

As all of you are no doubt aware, America's domestic petroleum industry has, in recent years, become a battleground for speculative stock raids, hostile takeovers and forced breakups. Since the Federal Trade Commission, the Internal Revenue Service and the Department of Justice have thus far taken essentially a hands off attitude about these events, I am hopeful that Congress will step forward and address this serious national issue.

The full extent of the recent industry turmoil can be seen in attachment one, which lists America's major integrated petroleum companies and their debt ratios five years ago and today. As this table shows, in 1980 there were 15 major integrated companies, almost all with conservative debt burdens, competing with each other in exploration, production, refining and marketing. But in less than five years, five of these companies have disappeared as independent entities, three others have taken on large debts, and another one (Phillips) has been seriously disabled with a burden of debt of record proportions. And now Unocal has been put "in play" (as they say on Wall Street), with the possibility of a takeover or liquidation staring us in the face.

Unocal has become a raider's target not because we are unsuccessful but rather because we have been successful. We have been successful in finding oil at low cost; we have been more profitable than most of our competitors and have provided better returns to our shareholders. We have kept our debt burden low so that we could aggressively invest in the finding and producing of oil and the development of alternative energy sources so necessary to our Nation's future. Mr. Chairman, when success in the harnessing of the Nation's energy resources brings on the destructive results of takeovers, then something is seriously amiss in our Nation's financial and tax system. The Tax Code is stacking the deck against companies like Unocal.

While some economists may support such moves in the name of "capital efficiency," I believe they are misunderstanding what is actually going on in our industry. In particular, I believe they fail to understand the possible adverse impacts on the Nation of the following four key points:

1. The disappearance of so many major competitors will lead to a concentrated industry dominated by a few giants—and to one that, as in the early 1970's, is dependent upon the whims of foreign oil producers. Other industries that have followed this pattern (e.g., autos and steel) have tended to become bureaucratic, inefficient, and short on innovative drive—and have found themselves at the mercy of foreign competitors. This last point is especially important. If the oil industry is

going to successfully explore America's frontier regions—particularly in Alaska and in deep offshore waters—and also develop needed alternative energy sources, such as oil shale, it will need all the centers of creativity and entrepreneurship it can muster. In short, it will need as many strong competitors as the Nation can possibly support.

2. Even when it is unsuccessful, the threatened takeover of a large company forces management to focus on short-term results and defensive tactics. Exploration, research and development, long-term planning, and even its rational decisionmaking are victims of the raid. Peter Drucker put it well in a recent article in the Wall Street Journal (October 30, 1984):

"It is increasingly hard to defend the unfriendly takeovers as benefiting anyone other than the raider (and a few investment bankers and merger lawyers). Anyone working with management people knows that fear of the raider paralyzes our executives. Worse, it forces them into making decisions they know to be stupid and to damage the enterprise of their charge. A good many business leaders I know now hold takeover fear to be the main cause of the decline in America's competitive strength in the world economy. . . ."

3. Substantial increases in debt, incurred either to finance an acquisition (e.g., Chevron) or to defend against one (e.g., Phillips), are not healthy in an industry that has high fixed costs and is vulnerable to price swings due to forces beyond its control. Companies burdened with excessive debt service lack the cash for aggressive exploration and innovation. Companies without borrowing capacity may be unable to make needed expenditures for expansion. Companies with excessive debt are liable to failure and prone to avoid risks.

This point was recently well stated by SEC Chairman Shad in a discussion of the "Leveraging of America":

"Corporate takeovers and buyouts are financed through large loans. The net effect is that debt is being used to retire equity, which is known as leveraging up a company's capitalization. The greater the leverage, the greater the risks to the company, its shareholders, creditors, officers, employees, suppliers, customers, and others . . . the more leveraged takeovers and buyouts today, the more bankruptcies tomorrow."

4. The Nation's banking, S&L, and securities firms are greatly overextending themselves by financing highly leveraged multi-billion dollar oil company takeovers. A recent Forbes article, "An Idea Whose Time Has Gone" discusses the new phenomenon of S&L's "Financing Greenmail and Stock Speculation" as well as real estate speculation. Forbes says "that's potentially very lucrative but exceptionally risky, especially for S&L's already in such weakened condition that they have very little capital left to lose." And it's not really their money. It's entrusted to them by depositors, by taxpayers, by the American people.

Clearly, our banks and S&L's and securities firms should be concentrating on loans which create jobs and add to the Nation's real output, not on loans that benefit only speculators, takeover artists, and their lawyers. A further major drop in world oil prices, coupled with an increase in high interest rates—not unlikely events—could throw many of these high-interest, low-security "junk" loans into default or "workout" status. That could push many large banks and S&L's to the brink of failure, forcing a new round of Federal bail-outs.

Henry Kaufman of Salomon Brothers has pointed out that such deals removed between $80 billion and $90 billion of equity securities from the U.S. marketplace in 1984 alone—more than 4 percent of the total value of all U.S. stocks outstanding.

Now, let's turn to my industry and ask: Why is this especially happening to large oil companies?

First, let me discuss what is not the cause. It is not because this entire group of U.S. integrated oil companies somehow suddenly need to be "restructured," as claimed by Mr. Pickens in his testimony before another House committee on February 27 and elsewhere. If we carry Mr. Pickens' line of reasoning to its extreme, we end up with every one of the companies listed in exhibit one either being merged, liquidated, or "decapitalized" (that is, forced into a massive conversion of equity to debt, a'l Phillips). This is obviously not only an impossible result with impossible demands on the credit system, but a result that, even if partly achieved, would be severely damaging to the national economy and our Nation's energy security. It removes our capability to respond if—or when—the next crisis occurs.

As Eugene Nowak, an oil analyst at Dean Witter, said in a recent Washington Post article:

"(This restructuring is forcing) a strong orientation (toward) short-term performance and rewards at the peril of dramatically reducing future benefits. . . .

"If it continues, I think there are dire consequences for the long-term energy supplies of the United States, and perhaps (the trend could bring) on an energy crisis sooner, rather than later."

Now, let me shift to a discussion of what I think is the cause of this phenomenon. I believe this wave of mergers and takeovers is happening:

1. Because the tax system, which permits the deduction of interest on borrowed money used for successful, unsuccessful or even threatened raiding, favors debt over equity: And because it favors the so-called "investor" over the businessman—the raider over the defender;

2. Because enormous amounts of money have become available for speculative short-term deals as a result of the move to "deregulate" financial institutions; and some of those institutions are acting foolishly, considering their responsibilities. They are buying high-risk debt with other peoples' money and hoping it will all work out;

3. Because, with the emergence of junk financing, bidders can borrow 100 percent of the cost of an acquisition in advance, with little or no security, on the promise that they will bust up the target to repay the loan. This is what enables raiders to threaten targets many times their size;

4. Because of the emergence of a group of professional raiders, whose interest is not in the overall health of the economy or in helping true shareholders, but only in making "quick-turn" profits for themselves; and

5. Because, in the case of the oil industry, Mr. Pickens, has somehow created a speculative frenzy—his modern version of a South Sea bubble—that has convinced many on Wall Street that "there's easy money to be made in attacking oil companies, and to hell with tomorrow." But this bubble—like all bubbles—will eventually collapse, leaving wreckage of ruined companies, lost jobs, reduced U.S. oil production, failed banks and S&L's, and Government bail-outs.

Lest you think I'm exaggerating when I say that Mr. Pickens favors the "restructuring" of just about everyone (except, of course, Mesa, which is surrounded by several layers of shark repellent), let me offer some evidence.

In his statement before the Wirth committee on February 27, he provided a table which lists the major companies by name and purports to show a "gap" in value that his so-called "restructuring" would close. (See attachment two.) But Mr. Pickens' argument is phony. The appraised values on which it is based come from a report ("Herold's Appraised Values") that expressly states that they are not intended to be stock market values. And, as attachment three shows, the relative market behavior—that is, market price as a percent of Herold's appraised value—of the companies that have "restructured" themselves in recent months (Texaco, Mobil, and Chevron) is poorer than that of the companies that have not (Exxon, Standard of Indiana, and Unocal).

Thus, his "resturcturing" idea does not stand the test of analysis, and is revealed for what it is: A speculative scheme that takes advantage of the tax laws, the availability of easy money, and the greed of short-term speculators.

What is Congress' appropriate response to this "raiding-restructuring" mania?

We urge action in these areas:

1. The most urgent need is for a quick moratorium on hostile takeovers—a sort of "cooling off" period during which the Nation has a chance to pause and think about what's going on, the speculators have a chance to realize that this speculative chain letter can't go on forever, and Congress has a chance to make some needed changes in the Tax Code and possibly elsewhere. H.R. 998, H.R. 1182 and S. 473 are bills that call for such a moratorium.

2. The Tax Code should be revised to end the tax subsidies that encourage hostile takeovers. Increasingly, businessmen are realizing the need for such a step. Even Edgar Bronfman, chairman of Seagrams and himself a player in the takeover game, reached a similar conclusion when he asked himself, in a New York Times essay: "But What of The General Economy?" To use his words:

"If the interest on corporate takeover money borrowed specifically to buy the common stock of another corporation were not tax deductible, as it now is, such activity would be sharply curtailed. To the extent that it was not, Federal tax revenue would be increased and the average taxpayers would thus far not be, as they are now, indirectly footing the bill for part of these corporate-takeover games.

"What would change is that unfriendly takeovers would become discouragingly expensive and large amounts of bank credit would not be used to enrich a few shareholders, discharged executives, arbitrageurs, lawyers and others without real benefit to the economy as a whole.

"The tax-deductibility of interest on such loans is now, in effect, a Government-issued benefit and hence an intervention in a more desirable laissez-faire economic trend.

"So let's stop this tax benefit to corporations that encourages using credit to make money for a few. And let's try to get back to the successful, pre-eminent American enterprise system, instead of just moving huge sums of tax-deductible finite credit around."

In addition to disallowing the interest deductions, Unocal believes there should be special punitive taxes imposed on "greenmail" payments, that odious but often irresistible form of legal blackmail. H.R. 1100, sponsored by Congressman Jones of this committee, S. 286, S. 420, S. 476, S. 414, and S. 632 are bills that deal with these tax issues.

3. There is also a legislative need to correct the general rules of the takeover game—so that we would have, in the words of former SEC Commissioner Sommer: ". . . a level playing field." Attachment four, an article by John F. Lawrence from the Los Angeles Times for February 17 1985, titled "Market Rules Favor Raiders, Allow Abuses," speaks in some detail to these matters. H.R. 1074, H.R. 1075, S. 631 and S. 706 are bills that deal with issues of this nature.

In addition to the above legislative action, I believe Congress has an appropriate oversight role in raising the merger-takeover and related issues with the proper Federal agencies, especially those that have regulatory responsibility for our financial system. Senator Proxmire, when introducing S. 706 (the Corporate Productivity Act of 1985) referred to the possibility that ". . . the bank regulatory agencies (would) jawbone and discourage banks and other financial depository institutions from making loans to finance unfriendly takeover bids. Such an approach would discourage the purchase of junk bonds by savings and loan associations and also the financing of unfriendly takeovers by banks who have been involved in the past after having curtailed some of their lending activity to the lesser developed countries."

Let me close with these two final observations:

First, we feel quite strongly that the Pickens' approach to "restructuring" American's oil companies must be stopped for the simple reason that the idea is wrong, or at least being seriously misrepresented. The beneficiaries of Pickens' actions are not America's energy consumers, America's security, or even the small shareholders, but rather only a handful of shareholders, and, of course, Mr. Pickens himself, through his board's generous recent action in voting him a $27 million bonus (more than twice the common share dividends paid in 1984 to Mesa's shareholders).

Second, and finally, we want to point out that Unocal does not fit the mold of the companies that Mr. Pickens claims need "restructuring." Our long-term shareholders know that they have been well served by Unocal's approach to management and growth. For example, consider the following:

If, at the beginning of 1960, a shareholder had invested, say, $10,000 in Unocal stock, that stock would, at the beginning of 1985, be worth approximately $127,000. This stock appreciation, plus the dividends, would have yielded an annual rate of return of 15 percent on the initial investment. This is one of the highest returns that could have been realized by investing in any major oil company that survived this 25-year period.

By contrast, a $10,000 investment in a stock that represents an average of the remaining four U.S. international oil companies—Exxon, Chevron, Mobil and Texaco—would, over the same time period, be worth about $37,000. This stock appreciation, plus dividends, would have yielded an annual rate of return of 10.8 percent.

Unocal does not view America's oil industry as a sunset industry, as Mr. Pickens does, but rather as a place of opportunity—both for finding new sources of oil and gas and for developing alternative energy sources. Independent studies of our oil-finding record shows us to be among the industry's best. For example, a recent study by Arthur Andersen & Company found that Unocal's U.S. finding cost for oil and gas (converted to equivalent barrels) of $6.82 a barrel for the period 1980–83 was the lowest of the 16 majors in the study. Mesa's finding cost for the same period, by contrast, was reported to be $14.82 per equivalent barrel.

Further, our leadership in geothermal energy and oil shale development shows us to be among the industry's most farsighted. In addition, our leadership in maintaining an efficient refining system and in developing new refining processes for producing high quality products from low quality crude oils means that, come the next energy crisis, Unocal expects to be at the front line in providing Americans with urgently needed petroleum products. Where, I might ask, will Mr. Pickens be at that time?

Mr. Chairman and members of the subcommittee, too many fine companies have already been murdered, or nearly so, by Mr. Pickens and his ilk. To quote again from the earlier comments by Edgar Bronfman: "enough is enough." Unocal will compete with anyone when the game isn't rigged. You can help un-rig the takeover game and restore the free enterprise balance to financial and business affairs. I urge you to take all appropriate action to do so.

Thank you.

ATTACHMENT 1.—*Major U.S. integrated petroleum companies 1980 and 1985*

	Debt Ratio Percent
January 1, 1980:	
Atlantic Richfield	33.9
Chevron (formerly Standard of California.)	18.1
Cities Service	31.8
Continental	30.0
Exxon	15.9
Getty	4.7
Gulf	15.1
Marathon	40.0
Mobil	23.9
Phillips	14.9
Shell	33.8
Standard of Ohio	55.3
Sun	17.4
Texaco	24.5
Unocal (formerly Union Oil Co. of California.)	29.2
January 1, 1985:	
Atlantic Richfield	27.9
Chevron	46.8
(Merged into Occidental and then broken up)	.....
(Merged into DuPont)	.....
Exxon	13.3
(Merged into Texaco)	.....
(Merged into Chevron)	.....
(Merged into U.S. Steel)	.....
Mobil	46.2
Phillips	80(e)
Shell (now 100% owned by Royal Dutch)	.....
Standard of Ohio (now 53% owned by British Petroleum)	.....
Sun	30.2
Texaco	44.2
Unocal	18.2

ATTACHMENT 2

Simply put, shareholders are not realizing the true value from their investment. This is especially reflected in the major oil companies' appraised value versus market value. Here are some examples:

[In billions of dollars]

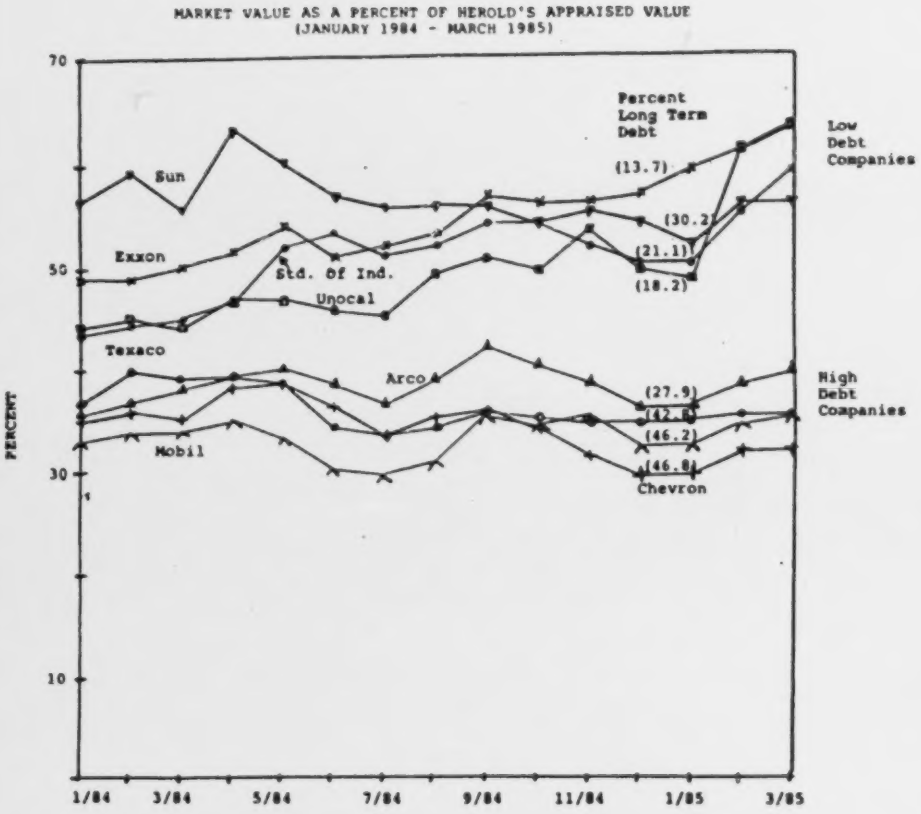
II	John S. Herold appraised value	Market value Feb. 25, 1985
Exxon	63	38
Arco	31	12
Chevron	37	12
Texaco	24	9
Mobil	36	12
Sun	10	6
Unocal	13	8
Standard Oil of Indiana	31	17

These companies must find a way to get their market value closer to appraised value. That is the challenge for these managements.

It should surprise no one that, in some instances, large stockholders have taken it upon themselves to force management to take action. That is what occurred at Getty, Gulf and Superior, and in such cases shareholder wealth increased. If management is unwilling to allow shareholders the opportunity to benefit from the untapped value of the company's assets, it is time for a change.

(Excerpt from pp 11-12 of T. Boone Pickens' testimony 2-27-85 before the House Committee on Energy and Commerce—Subcommittee on Telecommunications, Consumer Protection and Finance.)

ATTACHMENT THREE



Note: Herold's appraised value is calculated by adding estimated values for all of a company's assets and subtracting its long-term liabilities.

ATTACHMENT 4

[From the Los Angeles Times, Feb. 17, 1985]

MARKET RULES FAVOR RAIDERS, ALLOW ABUSES

(BY JOHN F. LAWRENCE)

Amid the desultory attempts to find a solution to the takeover binge, not much has been said about one of the most basic causes—the vast transformation of the stock market.

Put simply, the market has changed from a public marketplace, where the players are all essentially equal, to a professionals' market, overwhelmingly dominated by the trading of a relatively few managers of very large funds.

Essentially, it is this change that has made corporate raiding easy. Professionals can react quickly enough and with significant enough blocks of stock to make the market serve the raiders' purposes, giving them the inside track.

To date, much of the regulatory effort has been aimed at the way corporations seek to defend against the raids. As usual, the Securities and Exchange Commission and the stock exchanges are hung up on some supposed threat to the free market if they put any impediment in the way of corporate takeovers. They have yet to recognize that takeovers themselves are a major threat to the market.

UNEQUAL TREATMENT

Financier Felix Rohatyn put it succinctly in congressional testimony last year when he said that "tactics used in corporate takeovers . . . create massive transactions that greatly benefit lawyers, investment bankers and arbitrageurs, but often result in weaker companies and do not treat all shareholders equally and fairly."

He added: "I believe we are reaching the point where the integrity of our financial markets is in question and, after all, that has been the basis of our free enterprise system."

Former SEC commissioner A.A. Sommer Jr. speaks of four myths impeding reform:

That there is a level playing field. Instead, current policy and the nature of the market tilt the game strongly in favor of the raiders.

That takeovers are good because they boost the target's stock price. This notion ignores how the raiding company's stockholders fare or what the net impact is on companies and the economy.

That takeovers are needed to root out bad management. It appears that well-run companies are targets as often as not.

That takeovers assure the most efficient use of corporate resources. Evidence points in the opposite direction. Companies that have been taken over often end up weaker and perform poorly; they wind up with more debt and less permanent capital.

If the market is to continue to attract investment from individuals, then it must be a public market where liquidity—the ability to buy and sell at a relatively stable price—is maintained by an abundance of participants. It should not be the vehicle for professionals to seek substantial influence or control over the affairs of companies.

There would remain ample opportunity for seeking corporate control through agreements reached with management and directors or through a proxy contest, where the attacking group can seek shareholder votes on the merit of the management skills it can bring to the company. That's where the focus belongs, not on offers of quick profit in the stock market.

By permitting professionals to misuse the market, the government and the exchanges are permitting a major distortion of market price-setting. In the past, regulation, even if belatedly, has sought to correct, such abuses. After the manipulative practices of the 1920s contributed to the market's collapse, such things as secret investment pools and deliberate camouflaging of trading were outlawed. The speculative excesses of the late 1960s led to further reforms, though once again not before another major collapse.

Today's abuses may not be manipulation in the classic sense. However, raiders are permitted to amass huge positions before disclosure rules take effect and other investors know their true purpose. Because corporations sometimes pay them to back off, raiders often assure themselves of profit whether or not they capture their targets. With the potential takeover aborted, individual investors end up watching the stock plummet.

The time has come to focus on bringing regulation of the market into line with current problems.

[From Harper's magazine, January 1985]

[Reprinted with Permission]

THE BIGGEST KNOCKOVER—T. BOONE PICKENS AND THE END OF GULF OIL

(By L. J. Davis)

NEW YORK. THE REGENCY HOTEL, JUNE 5, 1984

As the long New York summer began in a steam bath of humidity and drenching gusts of rain, the stock brokerage firm of Spear, Leeds & Kellogg gave a dinner at the Regency Hotel on Park Avenue. Present were some sixty arbitrageurs ("arbs," to each other), specialists in the deceptively simple art of buying certain securities low—when, say, information reaches them that a merger or an acquisition is under way—and selling them high. No man there knew what the morrow might bring (the arbs would have given much for the information), but at the moment they had much to be grateful for. They were gathered to celebrate a famous victory and to honor the man who had brought it about, making them all substantial sums of money. Their guest was T. Boone Pickens, Jr., fifty-six, the chairman, president, and chief executive officer of the Mesa Petroleum Company of Amarillo, Texas. His feat was simple and astonishing: three months earlier he had driven the Gulf Oil Company out of existence.

On March 5, 1984, James E. Lee, the chairman of Gulf Oil, had finally acknowledged the obvious and submitted to the inevitable. His company had accepted a $13.2 billion takeover bid from the Standard Oil Company of California (Socal)—no thanks whatever to Pickens, whose raid on Gulf's stock during the previous eight months had brought them all to that fascinating moment. It was the largest merger in U.S. corporate history; the nation's fifth largest oil company, Gulf, would combine with the fourth largest, Socal, to form the third largest. Gulf would not survive, but Pickens and his allies—defeated, foiled, decisively trounced—would never sit on Gulf's board or occupy its executive suite. They would, however—although Lee could not find it in himself to say so—walk away with more than three quarters of a billion dollars.

At the Regency, the mayor of New York, Edward Koch, presented Pickens with a crystal apple in token of the vast and unprecedented fees the Amarillo oilman had brought to the city's financial community and, indirectly, through various forms of taxation, to its municipal coffers. Pickens was a man accustomed to singing for his supper, and he had come prepared. He produced a live monkey.

"I'd like you people to meet Jimmy Lee," he said.621

NEW YORK. THE UNION LEAGUE CLUB. SEPTEMBER 16, 1983.

It was the Friday morning before Yom Kippur when Larry Rand received a call from a banker in the mergers and acquisitions department of Salomon Brothers, the investment bankers. Could Rand, the banker asked, meet with some people from Gulf Oil, an important Salomon client, that noon at the Union League Club? Rand's schedule was tight; with the Holy Days coming, he planned to be home before sundown, and the atmosphere at the venerable old club was rarely conducive to haste. "They think," said the banker, "that they've got a Boone Pickens problem." Rand said he'd be right over.

There had been indications, of course. On September 2, and again on September 15, Dan Dorfman reported in his syndicated column that Wall Street rumors had Mesa buying and holding—taking a position in, in Wall Street parlance—Gulf stock; talk on the Street had Pickens controlling stock that amounted to between 1.5 and 2 percent of the company. Pickens and his broker, Allan ("Ace") Greenberg, of the New York brokerage firm of Bear, Stearns & Company, denied everything. ("My point of view is that if somebody asks you a question he shouldn't ask, you have every right to tell him a lie," Greenberg later explained.) About the same time, both the equity department at Salomon Brothers and Gulf's own financial people detected unusual trading activity in Gulf's stock. Somebody was buying a lot of it, and Gulf was not long in deciding who that somebody was.

Larry Rand is director and senior vice president of Kekst and Company, a firm that specializes in corporate public relations. He is not the person a company nor-

mally calls the moment its stock becomes the subject of a raid. But Rand possessed unique knowledge; he and his senior partner, Gershon Kekst, had encountered Boone Pickens before, most recently at KN Energy, a Colorado-based natural gas and pipeline company that, it was widely believed, Pickens was even now subjecting to a so-called greenmail raid. In a greenmail raid, a speculator assumes a powerful position in a company's stock (that is, he buys quite a lot of it); then lets it be known (or, if he is clever, allows the company's management to assume over his strenuous but purposely unconvincing denials) that he is planning an unfriendly takeover that will involve a purge of the executive suite; then allows himself to be bought out at a handsome premium by the officers thus panicked.

Pickens was believed to be a master of this lively but difficult art, and Rand seemed just the person to describe Pickens's method of operation. Rand was more than willing to do so, but he had another message for Gulf. "You people," he warned, "have a terrible reputation on Wall Street."

By a curious coincidence, this reputation stemmed directly from some previous activities involving not only Gulf but Pickens. Like Rand, Gulf had met Pickens before, although the experience seemed to have taught Gulf little. During the summer of 1982, Pickens had made his first big takeover bid, tendering for the stock of the Cities Service Company, the nineteenth largest oil company in the United States. In a complex and nasty little battle, Cities drove away his co-investors, (Pickens was attempting to conduct a raid with partners, a first) and almost succeeded in buying Mesa Petroleum out from under Pickens's feet. But in the end it was Cities, not Mesa, that went to the wall. Baffled at every turn by the almost insanely nimble Pickens, Cities was forced to seek safe harbor in the form of a corporate savior, a larger and friendlier company that would top Pickens's bid. On Wall Street, such a company is called a white knight. Cities' white knight was Gulf Oil.

By coming to the rescue of Cities, Gulf actually saved Mesa—and guaranteed Pickens an after-tax profit of $12.7 million when it bought back at a premium the Cities securities Mesa held. But for Cities, Gulf proved less a white knight than a broken reed. Confronted by Federal Trade Commission antitrust objections—objections many observers considered trivial; the oil industry is not a concentrated one—Gulf, with no warning, bailed out of the deal. Gulf's withdrawal left a great many arbs (and a great many amateur investors in search of a killing) holding a great many Cities Service securities whose price had suddenly if not surprisingly collapsed. It is doubtful that Charles J. Waidelich, Cities chairman, and the durable Dr. Armand Hammer, chairman of Occidental Petroleum, saved Wall Street and with it Western civilization, as some claimed, when they quickly moved to fold Cities into Oxy. But at least they were able to hold the arbs' losses to around $400 million—a figure that, understandably, burned its way into the arbs' collective memory. No arb likes to be caught holding the bag, and the bag in question was a particularly capacious one.

If Pickens were indeed making a run at Gulf, as Larry Rand at least half suspected, the arbs would be likely to pour their abundant resources into Gulf stock with even more than their usual enthusiasm, creating a perilously unstable situation. Moreover, much of Gulf's stock was held by large institutional investors—pension and mutual funds—which were loyal enough when the market was placid, but the responsibilities of which were fiduciary in nature. The primary responsibility of any fiduciary institution is to protect the money placed in its custody; if Pickens introduced enough volatility into Gulf's stock—if he, in the argot of Wall Street, put the stock in play—the institutions would probably dump their holdings. And if the arbs picked them up, and if Pickens played his hand cleverly, and if Gulf's defense lacked spunk and imagination, Gulf could be destroyed as an independent company. There was great danger here.

This, then, was the meaning of Larry Rand's warning. For all intents and purposes, the men from Gulf ignored it. They were much more interested in Pickens himself. If they could only figure out who the hell he was, they reasoned, they might be able to deduce what the hell he was up to.

There was little to go on. Pickens was born in Oklahoma, and he liked conservative suits. It was known that he was a Presbyterian elder and it was suspected that he was a pest. He was a very conservative Republican who had once voted for Lyndon Johnson, a staunch believer in physical fitness who had been known to take a drink. A onetime geologist with the Phillips Petroleum Company, he had founded the forerunner of Mesa at the age of twenty-seven with $3,500 in cash.

Located in the deserted heart of downtown Amarillo, a city whose streets appear to have been visited by a perfected version of the neutron bomb, Mesa was as close an analogue to the furnishings of Pickens's mind as Gulf was likely to find. But an examination of the company revealed little that was useful beyond the fact that it is

a taut ship with a mildly eccentric captain. No tobacco is visible during office hours—Pickens detests smoking in all its forms. Nor does Pickens approve of office romances, even if the partners are unmarried. The showplace of the blue-and-beige headquarters building at One Mesa Square is the T. Boone Pickens Jr. Fitness Center, equipped with a jogging track, a weight room, and a brace of racquetball courts. Racquetball is Pickens's favorite game. The fitness center is dominated by a statute of its founder hotly engaged in the sport. "I always tell our new young executives—we're in the middle of a youth movement here—how I feel about exercise and good health," he said one day last spring, "and during their orientation period I make a point of telling them about the programs we offer and the store I set by them. You know, I find that close to 100 percent sign up."

He is an equally keen fan of the speaker phone, with similarly apostolic results. Every qualified executive not only has one but uses it constantly, so that a stroll through headquarters during office hours is a little like a visit to a college dormitory during finals week, when everybody—for reasons that can only be imagined—has decided to play old Bob Newhart records.

Although Pickens had recently been presenting himself as a champion of shareholder rights (of which, more in a minute), Mesa itself had been rendered as impervious to the unwelcome initiatives of its own legal owners as human ingenuity could make it. The company was incorporated in Delaware, a state whose laws are unmarked by a foolish sympathy for stockholders. Mesa's directors, like United States senators, serve staggered terms, making it impossible to overthrow the board at a single annual meeting. In addition, there are certain circumstances when a simple majority is not enough to pass a resolution; Mesa's bylaws stipulate that only a "supermajority" (75 percent) of the voting stock can carry the day. (Pickens professes to loathe the supermajorities of others.)

These measures are a serious barrier to mischief-making among Mesa's ordinary shareholders, of course, but that is not their primary purpose. They are, in fact, defensive measures—walls built between Mesa and ambitious outsiders. Mesa is a very, very difficult company to raid. But even if a successful raid were to occur, Pickens would be ready. Many executives, fearing or anticipating attack, arrange employment contracts for themselves, ensuring that they, like certain baseball players, receive a handsome salary for years after being dismissed. In the business world, these are known as golden parachutes, and Pickens has been loud in his denunciation of them. But he has a golden parachute of his own.

The foundation of Mesa's business is its stake in the great Hugoton gas field north of Amarillo. In the language of the oil patch, Mesa is an "upstream" company, confining its activities to exploration, drilling, and production. Unlike Gulf and other "integrated" oil companies, Mesa has none of the money-losing "downstream" operations—the refineries, the chemical and plastics plants, the tankers and pipelines and service stations—that, in the time of cheap energy and abundant supplies, were necessary (or so it was thought) to absorb the flow of "feedstock" from the wells. Pickens does not believe in downstream operations.

Over the years another conviction had taken form in his mind. In the United States, Pickens believes, petroleum bonanzas are a thing of the past. It is true that Mesa has consistently replaced its reserves—oil in the ground, as distinct from oil in storage. And it is undeniable that Mesa has made him a rich man. (In 1980, Pickens was the highest-paid executive in the country, with a before-tax income of $7,866,000.) But by the late 1970s he was certain that Mesa would never strike the equivalent of the East Texas field that had made his friends in the Hunt family wealthy beyond the dreams of avarice. Plenty of oil remained in the world, but it lay either in huge fields abroad that were at the mercy of radical and unreliable foreigners or in the so-called frontier areas of the United States—Alaska and the outer continental shelf—where drilling costs, Pickens insisted, were prohibitive and exploration a mug's game, however loudly Gulf and the other majors professed to believe otherwise.

In Pickens's view, the oil business in the United States was not yet played out but it was gradually winding down, and there seemed to be ample proof that this was so: with the exception of well-managed Shell, the major oil companies had consistently failed to replace their domestic feedstock with new discoveries, and their American reserves were therefore a sinking asset, one that was in the process of disappearing. Pickens believed the time had come for oilmen to find new ways of making money, but he did not believe they had to leave the oil business to do so. He had already tried that once. In 1974, Mesa sold off its cattle business, the only nonpetroleum subsidiary it had ever owned, at a $19 million loss. Pickens never diversified again.

There was no secret about his views; Pickens was a popular and eloquent after-dinner speaker, and unlike many corporate executives, he was adept at airing his opinions in the press. Nor was there any secret about his sole contribution to the science of practical economics; the investment community had fairly trumpeted his activities from the rooftops. Like all seminal ideas, Pickens's great discovery was based on a perception that was obvious, simple, and completely overlooked by everyone else. If major oil companies like Gulf were indeed depleting their reserves for cash—that is, liquidating their assets—they should acknowledge the fact. Rather than spending (squandering, Pickens would argue) that cash on, say, unprofitable downstream operations, the oil executives should be placing the money in the hands of their companies' legal owners, the stockholders. There was an obvious method of doing so, with implications that were pleasing. When a company is liquidated in the usual way, through bankruptcy, a trustee is appointed to oversee the distribution of its assets to its creditors and (if anything is left) to its stockholders. Under the ancient law of trusts, these assets first pass into the legal ownership of the trustee. Here a number of bright possibilities present themselves. For a trust is obviously not the same thing as a corporation. In fact, in certain ways it is a better thing. If an oil company transferred its wells to a trustee, the income from those wells would no longer be subject to corporate income tax. Under a trust, moreover, all of the income from the divested wells would be distributed to the stockholders rather than enter the company's cash stream, there to be spent (in Pickens's view) neither wisely nor well.

There would be an additional benefit, and important one. For years, the stock market has recognized that something is seriously amiss at the oil majors, even if the relevant companies have not. Because of this perception, the market has chronically undervalued the stock of almost every oil company, including Mesa, pegging the price of shares to the amount of the annual dividend rather than to a company's liquidation value, that is, the actual value of its assets. But if a company, or a portion of one, were undergoing formal liquidation through a trust, it would seem likely that the market would value the shares and trust certificates at a level that more closely resembled the company's true worth, presenting the stockholders with a potential windfall through the run-up in the price of their stock.

There was only one way to find out. In the broad light of day on November 1, 1979, Pickens created the Mesa Royalty Trust and poured into it properties representing half of Mesa's proven reserves, with estimated net future earnings of a billion dollars. Each Mesa stockholder received a unit of the trust for every share owned on the day of record, while Mesa itself retained 10 percent of the units.[1] As Pickens had predicted, the price of what had once been a single share of Mesa Petroleum—which was now a share of Mesa plus a unit of the trust—took off into the ionosphere. In July 1979, four months before the trust was established, Mesa was trading at around $40 a share on the New York Stock Exchange. By mid-January 1980, two months after the spinoff of the trust, Mesa was trading near $60 a share and a unit of the trust was fetching about $35. Two years later, after a pair of two-for-one stock splits and a series of giddy plunges in oil shares that marked the end of the OPEC-inspired petroleum bull market, Mesa still traded at around 17¼ (for a pre-split valuation of 69), while the trust units fluctuated between 19½ and 40¼. Mesa stockholders had done well by the trust spinoff. Having retained 10 percent of the trust, Mesa itself was as happy as the other stockholders; moreover, a substantial portion of its corporate tax disappeared. It was impossible, of course, but it appeared that Boone Pickens had proved that two minus one equals four.

Gulf, like the other majors, had observed the situation, studied the concept, and rejected it. The money generated by its wells was badly needed to feed its huge, deficit-ridden downstream; every penny was precious. To this, Pickens would later have a simple reply: if a downstream loses money, get rid of it. But to a company like Gulf, the notion of growing significantly smaller was unthinkable.

Creating the trust had been an illuminating and instructive experience for T. Boone Pickens, and perhaps it would also prove to be a useful one. The world of corporate capitalism was an exotic place in the early 1980s, a field of sport and prizes. Pickens was looking for bigger game. In the popular mind (although he denied it), he was about to join the company of Bill Agee, Victor Posner, Saul Stein-

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[1] Mesa continued to develop the divested properties, a carefully selected mix of short-lived and long-lived wells, recovering, by arrangement, 90 percent of its costs immediately and recouping the rest, together with its profit, out of its stake in the trust. The holders of the remaining 90 percent of the trust units received what was left. It was, as the late Frederick Lewis Allen might have said, a masterpiece of legal humor. Pickens had divested himself of a full half of his company and, at the same time, he had kept it.

berg, and Rupert Murdoch. In the popular mind (although he denied it), he was about to become a corporate raider, a man who laid waste to the corporate landscape by inspiring terror.

There are two legal ways of making a great deal of money in the sort of capitalism that succeeded the Industrial Revolution. The officially preferred and more morally acceptable method consists of concocting a superior mousetrap, whereupon the world beats a path to the inventor's door, and he becomes rich. While the social utility of, say, Cabbage Patch Kids, ghetto-blaster radios, and telephones that play board games is doubtless a question that will murder the sleep of archaeologists yet unborn, this is capitalism at, presumably, its noblest.

The other, much simpler method consists of buying the stock of a carefully selected, publicly traded company and fiddling with the shares in one or more of a variety of creative ways. While this activity, for reasons that are more subjective than rational, has often been considered morally reprehensible, it is based on a fact of life that is remarkably uncomplicated. Ace Greenberg, Pickens's broker, once explained it this way: if a person labors for twenty years to build a house, and then proceeds to sell the place, he can't live there anymore. Shares of stock represent fragments of ownership in a company, a fact often forgotten. If someone buys enough of them, he can demand the key to the front door.

Although the public—or at least the press—has professed to be taken by surprise, there is nothing surprising about the corporate hubbub and the bold, lightning strokes of the 1980s; the floor of the stock exchange has historically been an exciting place. It is true that there had been a fifty-year lull during which the most creative speculators worked their colorful magic quietly or not at all, but this curious period of peace was due less to the reforms of the New Deal or the emergence of a new and altruistic breed of investor than to another pair of easily discernible circumstances. During the Depression and World War II, there was nothing much for the stock exchange to do, and in the immediate postwar years, American industry owned the world.

But by the early 1980s, American industry was no longer a money machine; many corporations were too large and too inefficient; many managers had lost their edge. Under such circumstances, it was hardly to be wondered that there existed numerous investors, themselves normally docile, who were willing to listen to a new arrival with (he said) a fresh idea, and even to join him in his quest for corporate reform, allying their shares with his in a joint crusade. Others, more cautious, simply sold him their stock when he was able to arrange a premium, either by forcing the price upward on the exchange or by making a "tender offer" for a fixed number of shares at a predetermined price. In either case, the result was the same; the raider got the shares.

While there is no way in the world that the management of a publicly traded company can stop an investor with bottomless pockets, there are ways to make his quest difficult, expensive, or too profitable to continue. Management can pay greenmail, of course. Of the other remedies available, "shark repellent"—staggered boards of directors, supermajorities, Delaware reincorporation—is perhaps the simplest. More difficult, and far more dangerous to the company involved, is the "poison pill" defense. In this ploy, a raided corporation pollutes the waters, perhaps fatally, by assuming a crippling burden of debt or by issuing more (and thus weaker) stock. Lastly, management might attempt the most difficult method of salvation, a "leveraged buy-out." Leverage is debt; in a leveraged buy-out, management puts up a company's assets as collateral on a loan, uses the money to buy back the company's stock, and then pays back the loan by selling all or part of the new, now privately held company. Whether or not anything useful is accomplished by this is a matter of some debate, but managers get to keep their jobs and, perhaps, make a little money.

All of these tactics were available to Gulf when its executives met with Larry Rand at the Union League Club. It only remained to be seen which of them the company would use, and how its defense would be organized.

Pickens, Gulf knew, had been a busy man. In the wake of the Cities ploy, he allowed himself to be bought out of Supron Energy, a Dallas company that had first attracted his attention in 1978, for a net profit of $22.2 million. At General American Oil, where he had maintained a position since 1976, he bid $40 a share for 51 percent of the company, forced it to seek a white knight in the form of his old employer, Phillips, and emerged with $25.3 million. He bought a 3 percent stake in California's Superior Oil, where the founder's children, Howard B. Keck and Williametta Keck Day, were engaged in a struggle that was ostensibly over Pickens's favorite issue, shareholder rights. (Mrs. Day was convinced that her brother had bugged her home; Pickens visited her and, totally unabashed, took the opportunity

to explain himself by addressing the walls and the empty air. Later he learned that the quarrel apparently originated long before, when Howard strangled Williametta's pet ostrich by stretching its neck through a picket fence and placing an orange in its mouth.) Pickens emerged from this experience with a net profit of $13.7 million. And he pulled Mesa out of Australia, withdrawing his operations to the safety and benign tax laws of the United States, with a pre-tax profit of $26.5 million.

It appeared to occur to no one at Gulf that Boone Pickens had raised a great deal of money in a very short time. Nor did it occur to anyone at Gulf that Pickens might make a serious run at the company. Gulf was the fifth largest oil company in the country; Mesa ranked ninety-second. Worldwide, Gulf employed more than 40,000 people; Mesa employed 700. Gulf's revenues in 1982 were $30,630 billion; Mesa's were $407 million. In 1982, Gulf lifted 182 million barrels of oil; Mesa produced 4.4 million. Gulf's worldwide properties were assessed at $20.4 billion; Mesa's oil and gas holdings, virtually the whole of the company, were worth $1.009 billion. Gulf owned or supplied thousands of service stations that sold 716,000 barrels of its refined products every day; Mesa's entire production of oil and natural gas condensate was 10,403 barrels a day. Gulf had once virtually owned the country of Kuwait; Mesa wasn't even the largest company in Amarillo.

Although the relevant executives believed that a serious attack on a company as immense as Gulf was patently ridiculous, they did detect one small, annoying window of vulnerability. Gulf was a Pennsylvania corporation, and Pennsylvania law required "cumulative" voting for boards of directors: in effect the owner of each share of Gulf stock cast thirteen votes. These votes could be distributed, one for each of the thirteen seats on the board, or they could be cast in a block for a single seat; a shareholder with 7.2 percent of the company's stock had the power to place his representative (or himself) on the company's inner council. This, Gulf figured, was obviously Pickens's plan. He would elect himself to the board, fog up the atmosphere with a lot of bumf about his royalty trust, and generally make a nuisance of himself until he was bought out. Very well, the problem was easily solved. Gulf would reincorporate in Delaware, where there was no cumulative voting, and it would do so as soon as possible, well before the annual meeting next May.

Pickens would be taken by surprise. If he chose to fight, he would do so on a ground and at a time of Gulf's own choosing. If the upstart Pickens persisted, he would learn a lesson he would never forget. And Larry Rand would obtain a valuable new client.

HOUSTON. THE LAW OFFICES OF BAKER & BOTTS. OCTOBER 29, 1983

Boone Pickens was a punctual man. The meeting at the Houston offices of his attorneys, Baker & Botts, began at precisely 9 A.M., the scheduled hour. Pickens, trim and carefully dressed, surveyed the room. "Thank you all for coming," he said.

It was the first all-hands gathering of the Gulf Investors Group, an alliance Pickens had forged three weeks before, on October 5, in a secret meeting at Houston's Meridien Hotel. During the Cities deal, the target had broken up his partnership. But the concept was sound, and Pickens was ready to try again. He chose his associates with care. Aboard were Mike Boswell of the Sunshine Mining Company, a staunch friend during the Cities deal, and the Belzberg brothers, Sam, Bill, and Hyman (sometimes called "the mysterious Belzbergs" by the financial press because it knew little about them and found it difficult to believe the little it did know—the family fortune was based on a used-furniture store in Calgary, Alberta). Rounding out the group were Cyril Wagner Jr. and Jack E. Brown of Wagner & Brown, an oil and gas partnership, and John M. Harbert III of Harbert International, a closely held Alabama construction and real estate firm. They had learned the identity of the target on October 5, although some of them had guessed it from the background material Pickens had provided before that meeting. None of them were intimidated. They were all still in.

From August 11, when he had first instructed Ace Greenberg to begin purchasing Gulf stock, to the first meeting of the investors group on October 5, Pickens had been horribly vulnerable to the one sure and effective counterattack Gulf could have made, a counterattack that would have halted him in his tracks and destroyed his life's work. Again, the Cities deal showed the way: Cities, in yet another all-time first, had tendered for the stock of Mesa, its attacker, before Mesa could tender for it. Gulf was far wealthier than Cities Service, and could easily have offered a handsome price for Mesa; the institutional holders of Mesa's stock, bound by their fiduciary responsibilities, would have had no choice but to offer up their shares.

But Gulf did nothing. The fact was, Gulf was large and rich—and weak. Founded in 1901 by Andrew W. and Richard B. Mellon as the J. M. Guffey Petroleum Compa-

ny, it was the only American oil major that did not join Aramco, the consortium that long dominated the rich production of Saudi Arabia. Gulf concentrated instead on its abundant finds in Kuwait and Venezuela, developing an extensive downstream operation in Europe solely to process and distribute the Kuwait feedstock. But the Kuwaiti and Venezuelan fields were nationalized in 1975, leaving Gulf with its European refineries, which made no money, and the European marketing apparatus, which made very little. The company's worldwide production fell by 80 percent and its return on equity shrank to 9.5 percent, well below the industry average. In 1976, chairman Bob R. Dorsey and two vice presidents resigned in a bribery scandal—among the pay-outs was the standard $100,000 unreported contribution to the Nixon re-election campaign. Expecting a boom in nuclear power, Gulf went heavily into uranium production, investing $419 million in a mine at Mount Taylor, New Mexico. The nuclear power industry did not boom. In 1964, believing it had hit a vast pocket of natural gas in the Gulf of Mexico, Gulf had negotiated a contract with the Texas Eastern Transmission Corporation that required Gulf to do one of two things, whichever came first: deliver gas for twenty-six years or deliver 4.4 trillion cubic feet. Either way, Gulf had to provide the gas at the fire-sale price of between nineteen and twenty-one cents per thousand cubic feet. But Gulf hadn't hit gas—it had hit water. With its great discovery a bust, Gulf found itself buying gas dear and selling it cheap in order to make up the 500-million-cubic-foot daily minimum stipulated in the contract; between 1972 and 1976 even this proved impossible. In 1982, Gulf paid Texas Eastern a refund of $45 million and another $48 million in interest, and it still had a trillion cubic feet to go.

There was more. Like many of the majors, Gulf had too many people doing too little work. Its stateside refineries began to lose money as conservation measures began to take hold, creating a surplus capacity; its marketing apparatus was overextended; its chemical and plastics divisions ate money. Moreover, it never seemed to find as much oil as it pumped. Just as Pickens said, Gulf was liquidating.

A royalty trust, if it worked the way Pickens believed, would rectify this deplorable situation. It would also (and not incidentally) make Pickens and his partners a great deal of money. But a trust was not the only way the trick could be turned. If Gulf successfully resisted the trust idea, Pickens and his partners would obviously be left with a great deal of stock, but they would not be all dressed up with nowhere to go. There would be no question of dumping the stock—the price would instantly head south, which was hardly the point of the exercise. The point of the exercise was to make money. It would therefore be necessary to find a way to put the stock in play, to render its price unstable. There are several tested ways of driving the price of a stock upward; all it takes is money.

If it became necessary to go the stock market route, Pickens had reason to believe that he possessed a powerful ally, almost a fifth column, in the form of James Lee's demonstrated lack of comprehension of the mysteries of the marketplace. Like many corporate bureaucrats—and Lee was the very model of the modern corporate bureaucraat—Gulf's chairman and the men around him had little practical understanding of the stock exchange, where the battle would be joined; no one who knew the faintest thing about the marketplace would have bailed out of Cities the way Lee and his people had done.

There was one other possible source of assistance inside Gulf. Harold Hammer, the company's executive vice president and chief administrative officer, would very likely direct Gulf's defense. Hammer believed himself to be something of a whiz at corporate strategy. But there were those among Gulf's closest allies who believed Harold Hammer was an unmitigated disaster.

Three weeks before the meeting at Baker & Boots, the Gulf Investors Group had bought 2,758,183 of the shares previously acquired by Ace Greenberg. In addition, the group agreed to raise $550 million for the next phase of the operation. Mesa pledged $365 million. The Belzbergs kicked in $50 million, and so did Harbert International and Wagner & Brown; Sunshine Mining, with $35 million, was the junior partner. All future purchases of Gulf stock would be coordinated through Mesa Asset, a wholly owned Mesa subsidiary created for the purpose. Ace Greenberg would by 6.3 million more shares, giving the group 8.75 percent of Gulf. This time, there would be no slip-ups. If Gulf made a run at Mea, the voting rights of the Gulf stock held by Mesa Asset would immediately and automatically transfer to Harbert International. The vast majority of the stock in Harbert International was held personally by John M. Harbert III. Gulf could buy every single share in Mesa Petroleum, throw Boone Pickens's desk into the street and chop it into firewood, raze One Mesa Square, sow the site with salt and divert a river over it, and the raid would still go on. Gulf's once chance of avoiding a fight was gone.

There had been few developments since the investors group first met on October 5. Lehman Brothers was retained as the group's investment banker. On October 17, as required by law, the investment group filed a Schedule 13D with the Securities and Exchange Commission, making itself known, identifying its members and the assets they controlled, and mentioning the possibility of a royalty trust. Ace Greenberg was buying openly now. On October 21, he purchased 2.5 million shares at $47.25 a share, one of the largest single cash transactions in the history of the New York Stock Exchange. On October 24, the group amended its 13D and revealed that its holdings had reached 17,932,700 shares, or 10.8 percent of Gulf.

Meanwhile, Gulf had finally begun to move. On October 11, the company announced that it proposed to reincorporate in Delaware; a stockholder meeting would be held in early December to ratify the decision. The purpose of the step, one Gulf executive told the press, was to keep a "Wall Street wolf" from "shooting his way into the board." A company seeking to reincorporate must file proxy materials with the Securities and Exchange Commission before holding any special stockholders meeting. Proxies are ships of paper that represent voting rights on shares of stock. On October 26, Gulf filed its proxy materials with the SEC, and Pickens and his associates studied them closely. To their amazement and delight, they discovered that Gulf proposed to do absolutely nothing but reincorporate itself. There was to be no stronger shark repellent—no staggering of board terms, no supermajority. Gulf thought Pickens wanted nothing but a seat on its board.

No sooner had Pickens thanked those on hand at Baker & Botts for coming than he turned to Donald Carter, one of the many specialists engaged for the struggle.

"And now," Pickens said, "Don Carter will tell us how we're going to win this proxy fight."

Carter was a man after Pickens's heart: young at thirty-six, aggressive, humorous. In the arcane world of mergers and acquisitions, he was an information agent, a specialist in the solicitation of proxies. It was Carter's job to obtain these slips of paper (and the votes they represented) for his employers, a task that required nerve, energy, and skill, qualities Carter possessed in abundance. He was especially adept at locating the real owner of stocks held in "street name"—that is, in the name of the brokerage where the stockholder maintained his account. But how he did this he would not say.

Carter didn't think the investors group could win the proxy fight—nor was he prepared to formulate a strategy. Nevertheless Carter, as usual, was at no loss for words. He realized that by calling a special stockholder meeting in early December, Gulf had provided Pickens and his partners with a priceless gift: time. Gulf stockholders, Carter explained to the group in the law office, had not been scheduled to meet until May—seven months off. Now, Pickens would have a chance to introduce his royalty trust—an idea not easy for ordinary investors to grasp—in December; he would have the balance of the winter and all spring to explain the plan.

Pickens told Carter to go back to New York and start work. It was time to get cracking.

PITTSBURGH. THE DAVID L. LAWRENCE CONVENTION CENTER DECEMBER 2, 1983

It was snowing and bitterly cold when 3,000 Gulf stockholders filed into the David L. Lawrence convention center for the special reincorporation meeting. Don Carter had flown into town at one-thirty in the morning aboard one of Pickens's three jets. A local television crew was waiting to record his arrival. In Pittsburgh, the capital of the Rust Belt, the battle for Gulf was the biggest story in town.

The proxy fight waged in November had been the largest and most expensive in American corporate history. Pickens admitted to having spent $7.5 million, and Gulf's expenses may have run as high as $9 million. Mesa's gray-haired, thirty-five-year-old vice president for finance, David Batcheldor, had pounded the pavements. "We'd do the rounds of the big institutional investors and talk about how we opposed reincorporation," he later explained. "That takes about thirty seconds. Then we'd spend the rest of the time explaining the royalty trust."

Unexpected support for the concept of a royalty trust came from the influential New York brokerage house of Donaldson, Lufkin & Jenrette. Word circulated in London and New York that Pickens was on the verge of acquiring an Arab partner, possibly a Saudi; Pickens had no such prospective partner, but he artfully refused to comment. Lehman Brothers drew up a "black book" for the investors group, projecting the probable effects if Gulf spun off 10 percent, 25 percent, 50 percent, 75 percent of its reserves into a trust. Gulf countered with a "white book" challenging Lehman's figures.

Pickens, giving every appearance of enjoying himself hugely, held a briefing for over 200 financial analysts in the Empire Room at the Waldorf-Astoria in early November, where he told the world that the investment group would never allow Gulf to buy it out. There would be no greenmail: he and his associates were advocates of shareholder rights. On November 22, Ace Greenberg again began to buy stock. (By law, he had been forced to stop buying for three weeks during a "standstill" period, while the Federal Trade Commission examined the antitrust implications.) He especially bought stock that had been held before October 21, stock with valid proxies attached; no share traded after that date could be voted at the special meeting.

Gulf, meanwhile, had assembled its team. Georgeson & Company and D. F. King—firms that had more or less owned the business before Don Carter appeared on the scene—were engaged as information agents for $175,000 a month and expenses; Sullivan & Cromwell and Reed, Smith, Shaw & McClay were assigned the legal work. Salomon Brothers was formally appointed investment banker and assigned a fee of $200,000 a month. (Lehman Brothers, the investors group's investment bankers, was to receive from the investors group a minimum of $1 million and possibly as much as $7.5 million, but only if Mesa was taken over.) Gershon Kekst and Larry Rand were assigned public relations.

Many of Gulf's tactics had seemed strange to those on the sidelines. The company's line of credit was raised from $1 billion to $5 billion. "Let's just say for the moment that we're strapping on our six-shooters," one of Gulf's advisers had told the press. But the fresh money was not used. And as if the white book were not enough, James Lee and his council of war met in New York with a number of security analysts and explained why a royalty trust was a terrible idea. Pumping bullet after bullet into their own feet, Gulf executives padded around in David Batchelor's footsteps, talking about liquidation and spinoffs and cash flow. In newspaper ads and a veritable blizzard of letters to its shareholders, Gulf dissected the trust concept, suggested that Pickens would never be able to sustain his investment and was therefore nothing but a mischievous greenmailer, and in general pushed its corporate invective to the limits permitted under prevailing regulations. Lobbyists were dispatched to Washington to urge legislation that would cripple royalty trusts, spreading the word to a new quarter. The upshot, of course, was that everybody who was supposed to be talking about reincorporation was talking about royalty trusts—just as Pickens and Carter had hoped.

Meanwhile, Harold Hammer, Gulf's field commander for the proxy fight, seemed to have taken leave of his senses. Hammer told the press that he was going to "wear the black hat. We've got to kick him where it really smarts." A Gulf spokesman tried to dismiss Hammer's remark as "an isolated, single incident," but it was no such thing. "Who is Pickens anyway?" Hammer remarked to a Fortune reporter, "Everything he says is horse—— and hot air. You can take a high road or a low road, and I'm taking the low." It did not seem to occur to Hammer that carrying on like this was not exactly a good idea, in view of the fact that he was an officer of a major oil company, hardly one of the country's more beloved institutions. Nor did it seem to occur to anyone at Gulf that hiring private detectives to dig for dirt in Pickens's background (and letting Pickens find out about it) was hardly an inspired stroke of tactical genius.

Gulf had more than 30 million shares of repurchased stock in its coffers, but there was no poison pill—the shares were not used to dilute the outstanding issue, which would have weakened Pickens's position and eaten into his cash reserves as he made up the loss. And there was no talk of a leveraged buy-out.

"I can't understand what Gulf is doing," an investment banker told the Wall Street Journal. "I know the people they've hired in the street and how they think. Gulf can't possibly be listening to them."

If the stockholders attending the special Pittsburgh meeting expected to hear James Lee deliver a spirited and detailed defense of his stewardship, they were sadly disappointed. And yet if Lee had wished to, he could have told a stirring tale. It so happened that the Gulf chairman agreed with Pickens: Gulf had indeed been liquidating itself. But Lee had been very effectively doing something about it.

Like Pickens, he was a Presbyterian elder, but unlike Pickens, he looked the part: courtly and balding at sixty-two, he more closely resembled a Sunday-school superintendent than the chief executive officer of a corporation whose budget was larger than that of many countries. He joined Gulf as a chemical engineer in 1943 and remained there for the next forty-one years, slowly ascending the corporate ladder: he became president in 1973, escaped the purge of 1976, assumed the chairmanship (and became CEO) in 1981. As too often happens in corporate America, it was only then that he was able to strut his stuff.

Some officers and employees he encouraged to retire; others he fired outright. (In 1981, Gulf employed 58,000 people. By 1983, the number was 42,700 and falling.) He began to repurchase Gulf stock on the open market; return on equity rose to 9.9 percent.

He pulled Gulf out of continental Europe, selling the company's installations to Royal Dutch/Shell and the Kuwait Petroleum Company for $258 million. In the United States, he assembled a trillion cubic feet of natural gas to satisfy the Texas Eastern contract; sold the refinery in Santa Fe Springs, California; retooled the others to take heavier and cheaper feedstock; and closed or sold 1,100 service stations in upstate New York, Vermont, Michigan, and northwestern Ohio. He sold unprofitable chemical plants and concentrated on plastics, where sales were up. Most importantly, he began to find some oil.

Domestic reserves did fall from 865 million barrels in 1980 to 723 million barrels in 1983, but the company's total world reserves were virtually stable, dropping slightly from 1.482 billion barrels to 1.472 billion. There were important offshore strikes at Ras al Khaimah, in the United Arab Emirates, and in Zaire, where Gulf owned half the concession. Production doubled in Angola, two new fields were discovered in Nigeria, and Gulf struck oil in the Celtic Sea off Ireland, where no one had ever found oil before. Lee, unlike his predecessors, also located new oil in the United States. More than half of any oil pool remains in the ground in a played-out field; under Lee, Gulf experimented with new technologies to bring that oil to the surface. Thanks to the revised leasing policies of the federal government, it became possible to explore entire subsurface geological structures rather than random portions of them; Lee proposed to conduct a vigorous search. He also set great store in the possibility of finding oil on the frontier. No one had ever looked for oil north of the Barrow Arch in Alaska, but Lee planned to do just that. There were promising geological structures off the California coast near Santa Barbara and off Point Pedernales, where a well drilled in 1983 tested at 4,300 barrels a day. Other likely prospects existed off the coast of Louisiana and in the Overthrust Belt of the Rocky Mountains, and there was still plenty of oil in the mature fields of Texas and New Mexico; in 1982, the first full year of Lee's tenure, Gulf drilled 1,095 development wells in the older fields.

In 1981, Gulf found 39 million barrels of domestic oil. In 1982, it found 53 million barrels, with 9,000 barrels a day coming from enhanced recovery techniques. Lee confidently predicted that by 1984, Gulf would replace its American reserves for the first time in years. The company would no longer be liquidating itself.

Here was something James Lee could seize upon, use to Gulf's advantage, throw up in Pickens's face as he sat among the stockholders. But, with force and unaccustomed eloquence, James Lee talked about royalty trusts.

HOUSTON. THE LAW OFFICES OF BAKER & BOTTS. JANUARY 5, 1984

Pickens, as usual, convened the meeting punctually. "And now," he said without preamble, "Don Carter will give us his analysis of the proxy vote and tell us what we have to do to win next time."

The week before, on December 30, the Corporation Trust Company, appointed to review and validate the votes and proxies cast at the December 2 meeting, had announced its preliminary findings. Eighty-five percent of the stock had been voted. Gulf carried the day with 52.7 percent, seven tenths of a point more than Carter had predicted in October, which was very good predicting indeed. The company immediately declared a mighty victory; making a rapid computation, Gulf spokesmen pointed out that if Pickens's own holdings were deducted from the total, he had been beaten by 3 to 1, a ratio that was decisive, crushing, humiliating, and final.

James Lee was not so sure. He knew Pickens—not well, but well enough to realize that he was tenacious. There would be, Lee suspected, a second proxy fight, at the May meeting, and it would be wise to be prepared. The steering committee that had handled the December 2 confrontation was expanded. There would be a media campaign (Lee would receive special television training). There would also be a fresh round of fight letters to stockholders, a new lobbying effort in Washington, and a series of speeches by senior management. May was four months off; Gulf thought it had all the time in the world.

This time, when Pickens called on him, Carter was ready. The investors group had not been idle. Ace Greenberg had purchased 457,000 more shares of Gulf, after which he withdrew from the fray. Mesa and its partners now owned 13.2 percent of the company. Carter distributed mimeographed sheets of figures and went to the blackboard for a little chalk talk. The situation was fluid, he explained. The stock was changing hands again as the arbs and other speculators took their profit on the

modest run-up that Pickens had caused. Carter suggested that the group pick up another 12 percent. Sam Belzberg interrupted him.

"Why go for just 12 percent?" Belzberg asked. "Why not go for the whole thing?"

PITTSBURGH. THE GULF BUILDING. FEBRUARY 1, 1984

James Lee put down the phone, stunned. That odious pipsqueak in Amarillo had just blind-sided Gulf real good.

It would seem that Pickens was a man of many unexpected talents. In addition to possessing oratorical and financial skills, he was also a consummate actor: for the past five weeks or so, he had treated Lee to a superb imitation of a man baffled by events. Neither by word nor by deed did he even hint that he was doing other than grasping at any straw that might enable him to salvage his investment. Late in December, on the very day that Corporation Trust made its preliminary report, the investors group formally presented Gulf with a sixty-two-page royalty trust proposal drawn up at Lehman Brothers; it claimed to show, with elaborate tables and exhaustive documentation, what would happen if Gulf spun off 50 percent of its proven reserves and 5 percent of its unexplored acreage. Pickens must be out of his mind. Gulf curtly rejected the proposal with a page-and-a-half letter.

A concerned stockholder, Pickens called Lee and complained about Gulf's expenditures in the Beaufort Sea, where the Cross Island well was an apparent bust and the Mukluk well, in which the company had a small stake, had just come in as a billion-dollar dry hole. Pickens also suggested that Lee sell Gulf Canada. He met with Lee and Philip E. Wyche, Gulf's vice president for exploration, to renew his complaints and to beat again upon that old dead horse, his royalty trust. Well, the man had to be accommodated. He and his group were the company's largest stockholders, and fair was fair.

But today Lee began to learn what Pickens had really been up to. February 1 would not be remembered as one of James Lee's better days. First of all, a memo began to circulate around the company. While Pickens was querulously airing his tired complaints, it seemed that he had formed something called the Gray Investors Group.

It would be some days before Gulf was able to lay hands on the actual Gray proposal, but its purpose was quickly deduced: Pickens intended to destroy Gulf in a new and entirely unanticipated way. And he was almost ready to strike.

The place to find the money, Sam Belzberg had told his fellow investors at the January 5 meeting in Houston, was the investment banking house of Drexel Burnham Lambert. The next day, Pickens found himself explaining the situation in Drexel's Beverly Hills office, where the New York-based firm maintained its high-yield-bond department. Drexel did not hesitate. Its emissaries went to Amarillo on January 12 to receive the necessary background information, and on January 21 Drexel was ready with a draft proposal.

To someone unfamiliar with the intricacies of high finance in modern America, the Drexel proposal remains all but incomprehensible. But it had one great advantage: it would work. To tender for Gulf at $55 a share, the price Drexel concluded would be the most feasible, Drexel estimated that Pickens and his partners would need $3.657 billion. The investment group would raise $482 million, Lehman would drum up a billion dollars from the banks, and Drexel would produce the balance by selling $450 million worth of senior notes—known in the trade as "junk bonds"—and $1.725 million worth of senior preferred stock in Newco, a company Drexel would weave from the filaments of dream. Another masterpiece of legal humor, Newco would toil not and neither would it spin; nor would it require a proper corporate name—Newco was simply a contraction of "new company." It would produce nothing, erect no edifices, and leave only one trace of its passage: it would murder another company, referred to in the Drexel proposal as "Gray" (read Gulf). If the figures were correct, the banks cooperative, and the Newco stocks and bonds marketable, Gulf was as good as dead and Drexel was worth every penny of its fee.[2]

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[2] Newco would first tender for 61.3 million shares of Gray's common stock at $55 a share; when combined with the Gulf investors group's holdings, this would give Newco a clear majority of Gray. Then the complicated part would begin.

Newco would spin off an equally fictitious (but equally legal) subsidiary, which would merge with Gray (Gulf). Gray's surviving stockholders would be rewarded for their tenacity with junior subordinated debentures—when the pie is sliced, the holder of a junior subordinated debt instrument is served last—and get more of Newco's preferred stock. Newco's senior noteholders would be repaid either thirty days after the merger or on December 15, 1984, whichever came first. The holders of senior preferred stock would receive a cumulative quarterly dividend of 14 per-

Continued

Except that Drexel was working for free. It had signed no contract and received no retainer. (It had been promised $500,000. A promise is not the same thing as a contract.) Drexel later claimed that its plan of raising more than $2 billion in three weeks seemed like an unlikely bit of business and that Pickens would have been justified in suspecting that it was impossible—and not worth paying for up front. Drexel (according to Drexel) therefore preferred to get to work and collect its fees only after it had placed the money in the hands of the skeptical but delighted Pickens. (One can only hope that this practice will spread.)

There was another explanation, however, one that makes more business sense. The moment Mesa and Drexel signed an agreement, the investors group would be obliged to amend its 13D at the SEC, publicly announcing the compact and its purpose. But as long as Drexel signed nothing and received no fee, the SEC—and Gulf—would never know anything was afoot unless someone talked.

Pickens always liked to move fast; the reason he left Phillips, he always said, was that the company proposed to take two years to drill a well he believed could be drilled the next day. On January 22, only twenty-four hours after the Drexel proposal came in, Lehman Brothers contacted Marine Midland, searching for the billion dollars in bank money; on January 25, Marine Midland agreed to study the situation in return for a $75,000 fee. February 23 had been selected as the day to begin the tender offer. Pickens and his aides were almost done making the rounds by the time James Lee obtained the Gray proposal; the circle of potential investors had grown to over 100. Citibank was in. The Harvard University Endowment Fund was in. So was the Teachers Insurance and Annuity Association. On Wall Street, someone seemed to know something; as Drexel's pieces began to fall into place, the price of Gulf common rose by 20 percent. The arbs, some of them, were beginning to take their positions.

And now James Lee knew something, too—not all of it, but enough. He was about to be attacked by a phantom from a direction he had never suspected. But word of Gray and Newco was only one of two pieces of terrible news he received on this first day of February. The other came in the form of a phone call from Robert O. Anderson, the chairman of the Atlantic Richfield Company (Arco).

Anderson had been heard from before. On January 22, Lee and Harold Hammer flew to Denver and met with both him and Arco's president and chief executive officer, William F. Kieschnick. Anderson proposed a merger but mentioned no numbers; Gulf, it was understood, would not be the surviving corporation. Lee said that he wasn't interested, but Anderson was not easily put off. On January 30 and again on January 31, he placed phone calls that were both very interesting and very fateful. The calls were placed to the Mesa Petroleum Company of Amarillo, Texas.

Arco, Anderson told Pickens when he reached him on the second try, wanted to make a 100 percent acquisition of Gulf, but it would not act in concert with Mesa or

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cent; a liquidation preference of $1.725 billion plus interest if (by some stroke of fate) it became necessary to lead Gray to the knacker's yard; an option to convert their stock into senior subordinated debentures (which Drexel estimated could be sold on the open market for $1.967 billion); and a firm commitment that, whatever happened, they would see their money and their profit within five years. They would also receive all of Newco's class-B common stock, which—since Newco existed only to absorb Gray—would give them a further 25 percent interest in the target.

As for the Gray Investors Group, it would own $762 million worth of Newco series A junior preferred, $735 million worth of series B junior preferred, and all of the class-A voting common, which represented the remaining 75 percent equity interest in Gray (Gulf). Series A junior preferred would pay no dividend. Series B would pay 12.25 percent and would be redeemed at the time of the merger, when other things would begin to occur.

At merger, Newco would borrow $3.351 billion—a simple matter, considering the $5 billion in credit that Gray had amassed in its war chest—and with it repay the banks and the senior noteholders while retiring $1.166 billion of Gray's outstanding debt. At the same time, the investment group's $735 million in class-B preferred would be redeemed and $285 million in interest would be paid; Gray's surviving shareholders, now entrapped in Newco, might be offered Gray's 60 percent interest in Gray Canada, but this would be decided later. Meanwhile, another mysterious entity, the Blue (as in Mesa) Petroleum Company, would move in to manage Gray's assets.

And what then? For starters, Newco and Blue would pay the remaining bills by tearing Gray apart and selling off the pieces, up to and possibly including Gray's domestic wells and undeveloped acreage. If that were to happen, the holders of Newco's senior debentures would receive between $520 million and $1.266 billion in additional cash, and although the Drexel proposal did not mention it, the investment group's additional share would be between $1.56 billion and $3.732 billion. There was one wrinkle. Because Newco's intended role as corporate assassin would become immediately apparent, and because Newco's structure made it impossible to attack and equally impossible to resist, it was likely that Gray would seek a white knight. And Pickens knew perfectly well that Gray was worth considerably more than the $55 a share that Newco would tender for. In short, Drexel was not merely proposing to make everybody a lot of money; it was proposing to make everybody an enormous amount of money.

the investment group. Would Pickens meet with him and discuss the matter? Pickens hedged. A meeting would not be useful, he told Anderson, unless Anderson could come in with a price higher than the 60s. Anderson called back an hour later. "We can get it to 70," he said. Pickens immediately flew to Denver.

It would have been relatively easy for Arco to acquire Gulf. In January 1984, Arco was the eighth largest oil company; more to the point, it was an excellent credit risk, and the battered banks, reeling from bad Third World loans and even worse loans in the oil patch, were in need of just such a client. At $70 a share, Gulf would cost around $12 billion, and the commercial loan needed to acquire it would be the largest in history. But with Arco's annual revenues of $27 billion and its cash flow of $10.1 billion, it was clear that Anderson could afford it. The only problem, he told Pickens, was that he wanted to make a friendly acquisition. And Lee was in no mood to be acquired.

Time was no longer James Lee's friend. In fact, James Lee had no time left at all. On February 1, Anderson repeated his offer and named a money figure. He had, Anderson added, already discussed the matter with Boone Pickens. This was terrible news. Anderson was offering $70 a share, and Pickens knew about it. There was no way of knowing what he would do with the information, but he was certain to do something. At the time Pickens began his run at the company, Gulf was trading at 38¼. It was now 57½, and the board of directors had not been born that could withstand the wrath of the assembled shareholders if it turned down a $70 premium like the one Anderson was offering. If word got out, Gulf was finished.

Charles Boyce, the company's secretary, was told to round up as many directors as he could find; Boyce located three of the thirteen. Lee told the assembled directors that he proposed to contact the heads of several companies. He called five. (Harold Hammer called a sixth.) One of them was George M. Keller, chairman of the Standard Oil Company of California. The two of them should keep in touch, Lee said. Boone Pickens was about to tender for Gulf. Lee hastened to add that he wasn't looking for a white knight. But Keller understood what he was saying.

PITTSBURGH. THE GULF BUILDING. MARCH 5, 1984

These things always took time. Gulf's board of directors had been meeting for hours, and still no word.

The board had already met twice during the preceding month. It held its first emergency meeting on February 10. Gulf had obtained a copy of the Gray proposal; Jay Higgins of Salomon Brothers critiqued the document. The board authorized three courses of action. First, Gulf would sue Mesa, the Belzbergs' First City Properties, Sunshine Mining, Drexel, and Bear, Stearns for market manipulation. Second, the company's line of credit would be expanded by an additional billion, to $6 billion, although this was no longer enough for Gulf to pull off a leveraged buy-out—Pickens had seen to that. Third, Lee would get more details from Anderson. At this meeting, Gulf's executives also prepared their golden parachutes. Gulf would later claim that no such thing had happened, and it was true that the board did not distribute employment contracts. Instead, it amended the stock option plan to enable management to get its money out in cash, either immediately or six months later, if the company was taken over. In addition, the board poured over $14 million into the Incentive Compensation Plan, $7,158,900 of it payable immediately, and it secured management's pensions.[3]

Lee never contacted Anderson; in fact, he canceled their scheduled meeting. The billion dollars in credit was obtained, but, typically, it was never used. The suit against Mesa went forward, but it was too little and too late.

Four days later, on St. Valentine's Day, Gulf was blown out of the water. Citing unnamed "Wall Street sources," Robert J. Cole of the *New York Times* broke the story of Arco's $70 bid. (Gulf was then selling at 57½.) Gulf immediately denied that any such offer had been made, but the denial had no more effect than King Can-

[3] On the day of the emergency meeting, Harold Hammer executed a stock appreciation right (SAR) on 95,000 shares in his stock option plan, selling at 57 and realizing a capital gain of $2,432,950. Pickens would later make much of this transaction, together with a similar transaction the previous November, in which Gulf's president and chief operating officer, Edward B. Walker III, had executed an SAR on 160,000 shares at 47, realizing a capital gain of $2,557,000. With some plausibility, Pickens would claim that two of Gulf's three top executives had not the faintest notion of the true value of their company's stock and that their subsequent denunciations of his activities were the merest eyewash. When the final tally was in, it was clear that Hammer, by selling early, had walked away from $2,185,000, pretax, while Walker, before taxes, had left close to $5 million on the table. Although some controversy surrounded the transactions, they were never reported to the SEC.

ute's marching orders to the sea; as far as the arbs were concerned, a trading ceiling had been established, and those who did not already have positions in the stock rushed to do so. Gulf Oil was as good as sold. It only remained to discover the identity of the buyer.

When the board convened again on February 14, the company's investment bankers warned that "market professionals" were taking positions in Gulf stock—in other words, the sidelines were emptying. There was only one thing Lee could try to do with a reasonable chance of success. He could try to prevent Boone Pickens from sitting in his chair.

Later, the accusations would fly thick and fast. Pickens and others would suggest that Harold Hammer, everybody's favorite villain, had leaked the story. (It was not Harold Hammer.) The Gulf people would point at Pickens, whose motives had the virtue of being clear, but it was not Pickens. Still others would suggest Don Carter. In truth, the source of the story could have been almost anyone. It no longer mattered. All the arbs were in.

On February 15, Pickens had abandoned Newco, a concept he had never been entirely comfortable with, or so he said. New circumstances required new tactics, and Pickens had never been a man to dwell in the past.

Gulf would later claim that its lawsuit against the investors group had destroyed Newco. But that was not the case. Actually, the Gray initiative was in splendid shape—in rather too splendid shape, as far as Pickens was concerned. To sweeten the deal, Pickens had promised his new partners 15 percent of the profits if he was outbid for Gulf, which was unlikely to happen as long as he was alone in the field. But if he got into a head-to-head bidding war with Anderson or the white knight Gulf would surely recruit, he would find himself giving away money that he would rather keep. For example, if he couldn't match Arco's $70 a share—and he couldn't—the Gulf investors group would make $553 million, but it would have to give $83 million to the Newco investors. There had to be another way.

While Pickens was thinking, Lee called John Harbert and offered to buy out the investors group for $70 a share. Harbert conveyed the offer to Pickens, and Pickens turned it down. Seventy dollars a share was no longer enough. Pickens believed he could get Gulf above that, and he believed he knew how.

He decided to tender for 13,500,000 shares of Gulf at $65 a share. With the stock already in hand, this would give the investment group 21.3 percent of the company, a significant figure. In view of the shareholder support Pickens had received at the reincorporation meeting, 20 percent of Gulf would be enough for the investors group to take over the company. If push came to shove, Pickens could spin off a royalty trust, perhaps sell the downstream operations, and sit back to await results, but probably none of this would be necessary. Such a move had been possible all along, but it was obviously the worst-case method of going about the task. (It had not been obvious at Gulf. Only now would memos make the rounds pointing out that Pickens had been entirely capable of taking over the company since *December.*) Now, with the Arco bid on the table, it was possible to pursue a different strategy. It was possible to execute the maneuver known as "doing a Dome." [4]

If no outside event intervened, Pickens's $65-a-share offer would probably attract a majority of Gulf's stock. It would then be possible to use the tendered securities as collateral for the loans that would be necessary to purchase it, since its true minimum value had been pegged at $70 a share by the Arco bid. Pickens could proceed according to the Gray proposal, gutting Gulf and selling off the pieces—but this bothersome procedure would also probably not be necessary. Not even Gulf could miss the message this time. To save itself from Pickens, it would have to sell itself immediately. And Pickens and his partners would make the money they had always known was there. Effortlessly.

It only remained to find the seed money needed to start buying. Drexel was ready with a candidate: the Penn Central Corporation, the diversified holding company that had emerged out of the wreckage of the Penn Central Railroad. Penn Central was controlled by Carl H. Lindner, yet another self-made man who gave no interviews, made a speciality of investing in undervalued companies, and was fond of distributing fourteen-karat-gold cuff links inscribed with such sentiments as "Only in America." In a complex deal involving subordinated notes, preferred stock, and

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[4] In the summer of 1981, indulging (or so it believed) in a spot of corporate blackmail, Canada's Dome Petroleum Ltd. tendered for 20 percent of Conoco Inc. Dome had no desire to own 20 percent of Conoco; it proposed to trade the stock for Conoco's Canadian subsidiary. Instead, Dome found itself awash in Conoco stock, with more than enough to take over the company. Conoco was forced to find a white knight (Du Pont), and lost its independent existence.

stock warrants—in effect, options to buy more stock in the future—Penn Central gave Mesa $300 million. Pickens was ready to make his move.

On February 24, amid denunciations by Gulf that had taken on the character of incantation and ritual, the tender offer had begun. Lee called George Keller, Socal's chairman, and told him that Gulf had prepared briefing books describing its reserves and other confidential matters; Socal could have access to them in exchange for assurances that it would not try to take over Gulf without Gulf's permission. Gulf stock was then trading at 62⅝.

On February 27, word leaked out that Arco was preparing its formal bid and had engaged Chase Manhattan as lead bank in a $12 billion loan syndication—on paper, the loan would be the largest in history, although in constant 1969 dollars it would be worth about $4 billion. The Allied Corporation was interested enough to ponder Gulf's briefing books, and GE, never a serious contender, was mentioned. Mobil was said to be in the running, and Socal's name appeared in the press for the first time. Amid heavy trading, Gulf stock hit 68½.

There were many stories, some of them true. The Kuwaitis were said to be interested in joining the fray; in all, seven companies were said to be poring over Gulf's briefing books. Gulf stock briefly hit 71½ before falling back to 69. Someone, it was never clear who, began to buy heavily in Texaco, which had recently acquired Getty for a then-record $10.1 billion. The Bass brothers of Fort Worth, who already owned 9.8 percent of Texaco, were fingered as the likely suspects, although the Basses, among the wealthiest men in America, traditionally invested for the long haul rather than the quick kill. But then, so did Penn Central's Lindner.

On March 1, Arco got its $12 billion as banks flocked from all over the world to join the syndication. Only a few months before, Morgan Stanley and Salomon Brothers had considered Gulf overvalued at $45 a share. Now, thanks to Boone Pickens, the financial analysts expressed dismay that Arco's bid was a mere $72 a share (up from the earlier bid of $70).

At Gulf, Mobil was out of the running; Kohlberg, Kravis, Roberts & Company, specialists in leveraged buy-outs, were in. The arbs began to move on Texaco. Reuters printed a rumor that the Basses had increased their holdings to 17.1 percent. Neither the brothers nor their father could be located. Pennzoil was with them, it was said; other rumors said it was Boone Pickens. Gulf stock reached 69½.

When the Gulf board met on the fifth morning in March, it had before it three firm offers. One, from Kohlberg, Kravis, Roberts, proposed a leveraged buy-out at $87.50 a share—$50 in cash and the balance in securities. Management would take the company private, pay off the debt by liquidating assets, and emerge with a handsome profit. Insiders reported that Harold Hammer was strongly in favor of the plan; forcing a leveraged buy-out, some said, was Hammer's motive in leaking the story to the *Times* about the Arco bid. But the KKR proposal had been hastily drawn, and it was late. A leveraged buy-out is usually one of the first options an attacked company considers, not one of the last; there were too many loose ends and too many uncertainties, and James Lee was not in favor of it. Hammer's plans had miscarried far too often. There would be no leveraged buy-out. The arguments dragged on. There were those who described Lee as a broken man.

There remained Arco's $12 billion and Socal's $13.2 billion. It was no contest. The message went out from the board: Would the New York Stock Exchange suspend trading in Gulf?

George Keller and Lee made a joint announcement: Socal would buy Gulf at $80 a share. The new oil company, third largest in the nation, would be renamed Chevron, after the Socal trademark.

Boone Pickens and his partners had just made $760 million.

NEW YORK. THE HELMSLEY PALACE HOTEL. OCTOBER 31, 1984

"Here you had Gulf, a company that was very large, and Mesa, a company that was very small, and I saw very early on that Gulf's attitude was like flicking a fly," Boone Pickens was saying. His suite in the Helmsley Palace was done in pearl gray; the chaos of lunch remained on the table. "Their hostile attitude was immediately clear. As far as they were concerned, I had no business there. Well, we were stockholders. In fact we were the largest stockholders in the company by the time we were done."

As the Gulf deal wound down, Senators Howard Metzenbaum and J. Bennett Johnston, a liberal from Ohio and a well-known friend of the oil industry from Louisiana, respectively, proposed a six-month moratorium on large oil mergers, which would have left Gulf in a dangerous state of limbo, unable to plan or raise cash. Lee

and his chief financial officer, James Murdy, hastened to Washington and begged not to be rescued, at least not like that. The moratorium was not imposed.

The Federal Trade Commission gave the Gulf-Socal merger its blessing with a single dissenting vote. In return, the FTC insisted that Gulf divest itself of some thirty wholesale gasoline terminals and vacate its interest in approximately 4,000 service stations in the Southeast. To avoid "anti-competitive effects" in the jet fuel industry, Gulf was ordered to sell either its refinery in Port Arthur, Texas (its largest), or the one at Alliance, Louisiana (its newest), and to find buyers for its 51 percent interest in the West Texas Pipeline and its 16.78 percent of the Colonial Pipeline. Until these transactions were completed, bringing in an estimated $1 billion, Gulf and Socal were to hold themselves separate.

For their part in the deal, Salomon Brothers and Merrill Lynch Capital Markets (brought in by Gulf in November) received $49 million, the largest fee ever paid to investment bankers in a takeover bid. Penn Central traded in its notes, stock, and warrants in Mesa for 14.5 million shares of Gulf, reaping a profit in the vicinity of $50 million. The Bass brothers, who had done precisely nothing, were bought out by Texaco for $1.28 billion, at a premium of $5 a share.

At Gulf, a great many people made a great deal of money, but nothing else of importance happened. Legislation was eventually passed making royalty trusts an unprofitable way of hiding money, but that was inevitable once the concept was explained to the relevant legislators; just as nature abhors a vacuum. Congress, in a time of record deficits, detests a tax dodge. A number of Gulf employees were certain to lose their jobs, but there was nothing new in that; James Lee had begun the dismissals, and he had resumed them after the December proxy fight. Gulf lost its independence but it did not go out of existence. It simply went somewhere else; its wells and refineries were not destroyed. Gulf's executives had their golden parachutes, and at least some of them became rich. From stock options alone, Lee was entitled to receive $6,715,000, a figure that was to be doubled by Chevron.

Months after the deal was closed and their company was well on its way to oblivion, the men at Gulf still seemed unable to see Boone Pickens clearly. "The guy is a failure in the oil and gas business," said James Murdy. "He put together a company, Mesa, and I give him credit for that. But he can't deal with the oil environment since 1976, and I think he knows it. He has a totally demoralized organization. He even forced his employees to build him a statue, which I think is a nice thing to do. Play golf with him if you want to find out what kind of a sport he is."

Pickens, as usual, had his own perspective. "Listen," he said, "we did Gulf a favor if they thought they'd find oil north of the Barrow Arch. I knew more about the drilling on Cross Island than Jimmy Lee did. He was crazy if he had that kind of dream. They just didn't have anything else to do with the money, and the last thing managements like to think of is sharing with the stockholders. That's what you get down to.

"Gulf kept saying what an awful guy Pickens was, at the same time they were saying what a terrific job they did for their stockholders," Pickens continued. "They keep saying that they won, we lost. That dog won't hunt. All this management was ever able to do, in the red-hot market of 1981, was get the stock up to 53. When we bought our first share, it was 37. They sold out to Chevron for 80. In their whole lives they could never have gotten it to 80; I don't think they could have gotten it to 53 again. Lee told me on February 6 that he wanted two more years. He thought he could get the price up to 60 or 65. I shook my head and wondered if I'd dozed off and missed part of the conversation. He had an offer from Arco for 70 on the table, and I asked him about it. You know what he said? He said, 'I was afraid you were going to ask that.' "

As might be expected, the commentators decried the colossal waste of it all, the feverish shifting of money from one pocket to another, the stupendous fees, the misdeployment of bank funds that might otherwise have been used for some noble social purpose. This is to misunderstand the processes at work. Unless it is destroyed, money never vanishes. By far the greatest portion of it returns to the economy, and thanks to Pickens, there is quite a lot more of it than there was before he set to work.

Chairman PICKLE. Thank you, Mr. Hartley, for your fine statement. We will come back to you with some questions in just a minute.

Next I would like to now recognize Mr. William Douce, representing Phillips.

Would you like to present Mr. Douce?

STATEMENT OF WILLIAM C. DOUCE, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, PHILLIPS PETROLEUM CO., ACCOMPANIED BY JOE O'TOOLE, VICE PRESIDENT AND GENERAL TAX COUNSEL

Mr. DOUCE. Thank you, Mr. Chairman.

It is a pleasure for me to be here today.

For the record, I am Bill Douce, chairman and chief executive officer of Phillips Petroleum Co., and I am accompanied by Joe O'Toole, who is our vice president and general tax counsel.

As you know, Phillips has been a target of two hostile corporate takeover attempts since last December. We have been one of many companies recently targeted by so-called corporate raiders that have been receiving considerable attention in the media, in Wall Street, and in the Congress.

Neither attempt was successful, but during this period much of our time, energy, and financial resources have been devoted to this activity. We have learned a few things in the process that I would like to share with you today.

I have already submitted a written statement for the record that outlines my concerns over the growing trend of hostile takeover attempts. I won't review these comments in detail, but I would like to summarize the major points.

I don't make it a policy of getting into a public dialog, with Mr. Pickens, but I want to set one point straight in the record that is being made today, and that is in reference to his comment about Phillips and greenmail.

The Phillips management at no time approached Mr. Pickens with the idea of paying him greenmail. That is a record we will stand on. That is in contrast to the statement I think he made, Mr. Chairman.

First, let me reemphasize that Phillips has been and remains a strong supporter of the free market system. The free market in this country has enabled Phillips to nurture its business over the past 68 years and grow to a position of prominence within the oil and gas industry.

I am an ardent supporter of the free market and believe that an economy which operates with minimum Government interference is the most productive. Within that free market system, corporate mergers and acquisitions can and do result in appropriate allegations of capital resources. I support this principle.

There are problems, however, that need to be addressed if we are to maintain a sound and growing economy over the long term. Within this context, we need to uphold the free market principles that provide for competition, shareholder equity, protection of employees, preservation of communities, and production of the goods and services deemed desirable by consumers.

Some hostile corporate takeover attempts now abuse these principles. The reason is that current laws contain provisions that give the takeover artist an advantage regarding high-risk financing and thereby encourages a short-term profit seeker to raid and attempt to liquidate otherwise profitable companies.

The goal of these individuals is simple—to force a short-term distribution of the target company's assets among the shareholders

through tax advantage means or, failing that, to force management into paying a premium to the minority shareholders in order for the company to survive the takeover attempt. This latter situation has been referred to as greenmail.

I believe there are serious negative consequences to these activities that deserve your review. Phillips has previously testified on February 27, before the Energy and Commerce Committee where we addressed other issues, including impact with employees and communities, philanthropy, and investment in research. I will not review these important points today, but I want to restate our strong feelings in those areas.

How can it be that corporate raiders are able to acquire a company like Phillips and finance the acquisition almost completely with debt? Part of the answer to this question lies within the thrust of our testimony today. Part of the answer may also lie on other aspects of Federal laws, such as antitrust and securities laws. Phillips intends to address these before other committees of the Congress as appropriate.

I would like to discuss some of these tactics with you in the hope that appropriate action can be taken to prevent the Tax Code from becoming a silent, unwilling partner in abusive, hostile acquisition tactics used by corporate speculators, raiders, and bust-up artists.

Typically, a corporate raider will acquire a small interest in a publicly traded corporation. The raider may then make a tender offer conditioned upon financing to make the offer. In the process of getting that financing, the speculator pledges security, which as Mr. Hartley has pointed out, are the assets of the target company that they don't even yet own.

The tender offer for the shares is usually of a coercive, two-tier variety. In a two-tier tender offer, the offer is financed by participating debt issued by a paper corporation with nominal assets controlled by the trader or by the raider. If the raider acquires the company, all or part of the company is liquidated and by selling assets and siphoning its cash flow into debt service. In short, the very attributes of an oil company which are necessary to protect the long-term value of the shareholders' interest are used to generate short-term gains of the acquisition.

To underscore my point, equity or cash flow funding is an important feature of the oil industry's capital structure. Substantial amounts of equity are necessary if a company is going to be effective in the oil and gas business. Unfortunately, under the present Tax Code, the equity component of an oil company's capitalization also makes a company vulnerable to corporate raids.

Sales of these assets will be largely sheltered from income tax because of the tax deductible interest expense on the so-called junk bonds used to finance the acquisition. If the raider does acquire control of the company, he can usually sell his shares to the target company at a premium price, commonly referred to as greenmail, at the expense of all of the other shareholders of the corporation. The raider may then frequently report the greenmail premium received for his shares as capital gains.

Because gains in the transaction are largely sheltered by the debt service on highly leveraged junk bond expense, the raider gets

a break that is not available to a company interested in continuing for the long term and maintaining its necessary strong equity base.

One of the most unfortunate aspects of the hostile takeover industry is the recent use of these highly leveraged junk bonds which are legitimatized by some major investment bankers and subsidized by our Government. This is—"the"—distinguishing feature separating abusive hostile takeovers from all other corporate mergers and acquisitions.

As I have said, the raider's objective is to acquire control of the company and distribute the equity on tax-favored terms. This is accomplished by the sale of assets and the diversion of cash flow to debt service and short-term gain and away from long-term projects.

For an energy company, this implies less exploration, less development drilling, less research, and that is not in the shareholders' long-term interest; neither is it in the long-term interest of this country.

We believe that the bill introduced by Representative Jim Jones and several members of this committee, H.R. 1100, and the companion bill introduced by Senators Boren and Nickles, S. 476, will bring an end to this abusive practice.

Professional speculators are utilizing high-risk financial instruments for their own short-term gain at the expense of long-term performance of financially-sound and profitable companies.

The Jones bill addresses the problems created by such actions, but is very limited in scope. The bill does not apply to mergers agreed to by the merging companies and it does not even apply to hostile takeovers utilizing assets of the acquiring company or investment grade securities. Specifically, it addresses only those instances where high-risk financial instruments are utilized to acquire another company.

In this latter instance, it is inevitable that the assets of the acquired company will be sold in order to retire the high-risk indebtedness.

To argue that such legislation is contrary to free market principles, I think is unsupportable. Such an argument is merely an attempt to disguise short-term, disruptive profit motives under free market principles.

The Jones bill also seeks to impose an excise tax on greenmail profits to help prevent a special group of shareholders from benefiting at the expense of other shareholders.

Mr. Chairman, there are other things I would like to say and many that I have in my written statement, but I thank you for the opportunity to share my thoughts with you and the committee today.

It is our hope that these hearing will help Congress better understand the real nature of these abusive takeover transactions and allow the corrective legislation embodied in H.R. 1100 to go forward.

Thank you.

[The prepared statement and attachment follow:]

STATEMENT OF WILLIAM C. DOUCE, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, PHILLIPS PETROLEUM CO.

Thank you Mr. Chairman. It is a pleasure to be with you today. The issues to be reviewed by your subcommittees are of vital importance not only to several oil companies such as Phillips Petroleum Company, but also to many companies in other industries and to the economy as a whole.

As you know, since December 4, 1984, Phillips Petroleum Company has been the target of two hostile takeover attempts. My comments will address some of the tactics used in both attempts to take control of Phillips. But first, let me explain a few things about Phillips Petroleum Company.

Mr. Chairman, I am, William C. Douce, the chairman and chief executive officer—and will be for about another month before I retire. Phillips is an integrated oil company with headquarters in Bartlesville, Oklahoma, where the company was founded in 1917. Phillips operates in 26 countries. Our products and processes are licensed in 31 countries.

Phillips is involved in all aspects of the energy business, including the exploration and production of oil and natural gas, and the refining and marketing of petroleum products. We also have a worldwide petrochemical operation and extensive mineral interests, including lignite coal, oil shale and uranium. We also have developed other alternative energy sources such as geothermal and solar power.

In addition to our energy operations, we have an extensive research and development function. We have an organization of more than 1,000 in our R&D staff. Phillips is a perennial leader in the petroleum industry with respect to securing patents.

Phillips has been, and remains, a strong supporter of the free market system. The free market in this country has enabled Phillips to develop its business over the past 68 years and grow to a position of prominence within the oil and gas industry. I am an ardent supporter of the free market and believe that an economy which operates with minimum government interference is the most productive. Within that free market system, corporate mergers and acquisitions can and do result in appropriate allocations of capital resources. I support this principle. In recent times, Phillips has been involved in enhancing its oil and gas business through productive acquisitions of reserves. In 1983, Phillips acquired General American Oil Company in a cash merger. In 1984, Phillips acquired Aminoil Inc. in a cash for stock acquisition. These acquisitions, both of which were friendly, enhanced Phillips' oil and gas reserve positions as well as its oil and gas exploration positions while at the same time leaving Phillips with a substantial equity base.

The arguments most frequently advanced against the enhancement of legislation to limit hostile corporate takeovers are that the securities markets must be allowed to function without additional government interference, that investors and company managers must be allowed to merge resources, that return on shareholders' equity should be maximized and, that shareholders must be allowed to replace inefficient managements. I support each of these principles as an integral part of the free-market concept. Having said that, I also believe that the type of hostile takeover attempts that have involved Phillips, as well as numerous other companies, are abuses of the free market principle. Moreover, I do not believe that any of the principles referred to above support or justify the disruptive, short-term, profit-motivated actions of professional speculators that are currently driving the rash of hostile takeovers occurring in our economy.

The petroleum industry is a high-risk, capital-intensive, long-term business. If an exploration project fails to find commercial oil or gas reserves, sizeable economic losses may be sustained. A company exploring for new reserves, therefore, must be sufficiently strong to absorb such losses without jeopardizing the shareholders' investments. Management cannot look solely to short-term gains if it is to meet its responsibilities to shareholders, as well as to the energy needs of our nation.

To underscore my point: Equity . . . or cash flow funding . . . is an important feature of an oil company's capital structure. Substantial amounts of equity are necessary if a company is going to be effective in the oil and gas business. Unfortunately, under the present tax code, the equity component of an oil company's capitalization also makes the company vulnerable to corporate raids.

As I indicated earlier, Phillips itself has become the target of hostile takeover attempts over the last four months. During that period, most of the time and energy of our employees, and the financial resources of the company have been devoted to combating abusive tactics used against us. These tactics have heightened our awareness of the tax benefits involved in hostile takeover attempts. We have become convinced that certain provisions of the tax code need to be revised in order to correct these abuses.

I want to note that while my remarks today will address the tax aspects of hostile takeovers, Phillips has previously testified on February 27, before the Energy and Commerce Committee where we addressed other issues including impacts on employees and communities, philanthropy, and investment in research. I will not review these important points today, but I wanted to restate our strong feelings in support of the points made in our earlier testimony.

How can it be that corporate raiders are able to acquire a company like Phillips and finance the acquisition almost completely with "debt"? Part of the answer to this question lies within the thrust of our testimony today. Part of the answer may also lie in other aspects of federal laws, i.e. securities law. Phillips intends to address these before other committees of the Congress, as appropriate.

My goal today is to review with you certain abusive tactics and apprise you of their tax effects in the hope of insuring that the tax code does not become a silent, unwitting partner in abusive hostile acquisition tactics used by corporate speculators, raiders and bust-up artists. In brief, the raider's objective is to acquire control and distribute the equity in the company on tax-favored terms. This is accomplished by the sale of assets and diversion of cash flow for a short-term gain and away from long-term projects.

What are the abusive tactics used by the corporate raiders? Let me share them with you.

Typically, a corporate raider will acquire a small interest in a publicly traded corporation. The raider may then make a tender offer conditioned upon obtaining financing to make the offer. The tender offer for the share is usually of a coercive "two-tier" variety. In a two-tier tender offer, the offer is financed by participating "debt" issued by a paper corporation with nominal assets controlled by the raider. The shareholders are usually given a cash premium in the first tier of the offer and then, in the second tier, after control is gained by the raider, will have thrust upon them low-rated, often subordinated, high-risk, high-yielding "debt" obligations, commonly called junk bonds. Confronted with such a two-tier offer, the shareholder must tender on the first tier or face the risk of being forced to accept significantly lesser value in the form of low-rated debt in the second tier. The wide spread between the values offered in the first and second tiers is clear evidence of the coercive nature of the offer. The debt obligations are generally worth far less than the cash offered in the first tier.

If the raider acquires the company, all or part of the company is liquidated by selling assets and siphoning its cash flow into debt service. In short, the very attributes of an oil company which are necessary to protect the long-term value of the shareholders' interests are used to generate the short-term gains of the acquisition. Sales of these assets will be largely sheltered from income tax because of the tax deductible interest expense on the high-yield securities used to finance the acquisition.

If the raider does not acquire control, he can usually sell his shares to the target company at a premium price, commonly referred to as "greenmail", at the expense of all of the other shareholders of the corporation. The raider may then frequently report the greenmail premium received for his shares as capital gain.

Drexel Burnham Lambert, Inc. is a leading proponent of junk bond financing. As described recently in Business Week (March 4, 1985, on page 90):

"Drexel's 'leverage' takeover works like this: The buyer sets up a new company on paper. Drexel creates a package of junk bonds to be issued by the paper company once it gains control through a tender offer. Then Milken (Drexel's head of its joint securities trading department) and his 125-person staff contact junk-bond investors, seeking advance commitments to buy the bonds. Once in control, the raider can raise cash by selling off pieces of his new property. 'We take a minnow, identify a whale, then look to its assets to finance the transaction', explains Michael D. Brown, Drexel's West Coast merger chief."

Thus, the minnow, having acquired the whale, cuts out its heart in order to finance the transaction. Because gains in the transaction are largely sheltered by the high leverage junk bond expense, the raider obtains tax write-offs that are not available to a company interested in continuing for the long-term and maintaining its necessary strong equity base. These abusive tactics should not be fostered by the tax code. Their curtailment should be directed at hostile acquisitions because this is the source of the problem.

Greenmail arises only in the hostile context. Congress, over the objections of many, enacted golden parachute rules that some have described as the equivalent of "management greenmail". There is no reason not to impose a similar excise tax for the receipt by special transient shareholders or groups of shareholders borrowing on

the dissected values of a business and then bailing out of the corporation and leaving the remaining shareholders in the lurch.

We believe that the bill introduced by Representative Jones and several members of this committee, H.R. 1100, and the companion bill introduced by Senators Boren and Nickles in the Senate (S. 476) will help avoid placing the U.S. Treasury in the position of being a silent partner with these speculators. And, I strongly believe that none of the free-market principles I reference earlier are compromised or impinged upon by this legislation. Professional speculators are utilizing high-risk financial instruments for their own short-term gain at the expense of long-term performance of financially sound and profitable companies. The Jones bill addresses the problems created by such actions, but is very limited in scope. That bill does not apply to mergers agreed to by the merging companies, and it does not even apply to hostile takeovers utilizing assets of the acquiring company of investment-grade securities. Specifically, it addresses only those instances where high-risk financial instruments are utilized to acquire another company. In this latter instance, it is inevitable that the assets of the acquired company would be sold in order to retire the high-risk indebtedness. To argue that such legislation is contrary to free market principles is unsupportable; such an argument is merely an attempt to disguise short-term, disruptive profit motives under free-market principles.

This legislation builds on, refines and clarifies concepts introduced in the Tax Reform Act of 1969. Then, Congress reacted against the use of certain convertible subordinated bonds, so-called "funny-money", in corporate acquisitions and dealt with the special problem in existence then by denying interest on the questionable "in-substance", equity securities utilized in such acquisitions. Today, a similar problem regarding interest expense exists which is not covered by existing law. That is, high-yield bonds used in hostile corporate acquisitions are essentially equity instruments with one important difference—they generate tax deductions to the issuing company.

The Jones bill is a focused attempt to adapt the current law and congressional policy against the use of "funny-money" in corporate acquisitions. These high-yield securities arising from hostile takeover attempts, because of their low status in relation to other debt of the corporation and because of the relatively small amount of equity typical in the transactions we are discussing (Mr. Icahn proposed debt of over $11 billion and equity of $800 million, a debt to equity ration of roughly 14 to 1), should not be regarded as true debt under the tax code. This is one of the key fundamental tax policy issues at stake because these securities bear all the hallmarks of equity. The same Business Week article discussed earlier refers to these so-called "junk issues" as offering the "possibility of enormous price appreciation, high yields, or both". These are the hallmarks of equity, not debt. In-substance "equity" distributions by a corporate raider (in the form of high-yield bonds) should not be accorded tax deductible interest expense treatment, enabling the raider to shelter gains on the sale of assets that could not be sheltered if the instruments used to finance the transaction were characterized consistent with their true nature.

H.R. 1100 also builds upon a provision introduced in the Tax Reform Act of 1984. There, Congress enacted legislation to impose an excise tax on recipients of golden parachute payments. A logical corollary to the policy behind the golden parachute rules is to also impose an excise tax for special payments made to allow one shareholder or a special group of shareholders to receive special benefits at the expense of other shareholders.

So . . . what can be done to end this partnership between the tax code and the corporate raiders? It is our hope that these hearings will help Congress understand the real nature of these abusive transactions and that this committee will conclude, as Phillips has, that a legislative remedy is needed to address these abuses of the free market.

Mr. Chairman, thank you for the opportunity to allow me to share my thoughts with you today.

[Attachment]

STATEMENT OF CHARLES M. KITTRELL, PHILLIPS PETROLEUM CO., BEFORE THE COMMITTEE ON ENERGY AND COMMERCE, FEBURARY 1985

Thank you Mr. Chairman. My name is Charles M. Kittrell. I am Executive Vice President and a member of the Board of Directors of Phillips Petroleum Company located in Bartlesville, Oklahoma. I appreciate the chance to appear before you this morning because, as you know, Phillips has been involved specifically over the last three months in activities which are the subject of your hearing this morning. I be-

lieve it is timely for the Congress to be reviewing the public policy issues involved in hostile corporate takeover attempts and want to specifically gear my remarks this morning to a few of the key principles I feel are appropriate for your consideration.

First let me describe Phillips. Phillips is an integrated oil company that has for the past 68 years been located in Bartlesville, Oklahoma, where it was founded in 1917. We employ more than 29,000 people worldwide and are involved in all aspects of the energy business from exploration, production, and refining, to marketing and research. We also are substantially involved in petrochemicals and minerals, as well as alternative energy sources such as geothermal and solar power research. Phillips operates in 26 countries while our products and processes are licensed in 31 countries. Our revenues last year exceeded $15.5 billion and our net income was about $800 million. We had a total tax expense last year of $1.2 billion, which covers the company's tax obligations to various state, federal and international governments.

U.S. BUILT ON FREE MARKET

The United States has been built upon a free market economy. The prosperity that this country enjoys today is fundamentally a result of our nation's unprecedented economic growth. I am a ardent supporter of the free market and believe that an economy which operates with minimum government interference is a correct and appropriate public policy. Within that free market system, corporate mergers and acquisitions can be and are appropriate allocation of capital resources. I support this principle. The ability of investors and company managers to merge resources, as well as the ability of company shareholders to replace inefficient management must be preserved. Having said that, I also believe that the kind of hostile takeover that has involved my company, as well as numerous other companies, is an abuse of the free market principal. Specifically, professional speculators are utilizing high-risk financial vehicles for their own short-term gain at the expense of the long-term performance of financially sound and profitable companies. In fact, the current rash of hostile corporate takeovers is so far-reaching that probably only a handful of U.S. corporations are not vulnerable to it. Surely, the managements of most of these companies are all not inefficient at enhancing shareholder value.

This leads one to ask, what has prompted the recent hostile corporate takeover attempts? One of the major reasons for this activity is the recent shift in the use of debt obligations, commonly called junk bonds, that allow speculators to pledge the assets of target companies they don't yet own to secure this high risk debt to finance their hostile bid. The junk bond market has grown substantially over the last few years. Issues of these high-risk, low-rated bonds have grown from about $2.5 billion in 1981, to over $14 billion in 1984. Concurrent with this explosion in the dollar amount of junk bonds issued, there has been a shift in their uses. No longer are these bonds used primarily by financially troubled companies who are unable to raise money through issuance of investment-grade securities. As demonstrated in the initial assaults on Walt Disney Productions, these bonds are emerging as a major vehicle to finance hostile takeover attempts on profitable, well-managed companies with a strong asset base.

It is, of course, obvious that some hostile takeover efforts are not seriously meant as attempts at takeover; rather, they represent an effort only to capture short-term profits for speculators. And, as you may know, there is a disquieting trend toward greater participation in junk bond financing by managers of large amounts of other people's money, such as money market managers, insurance companies, savings and loan officials, and to a more limited extent, pension fund managers. So, Mr. Chairman, from the standpoint of corporate activity in the marketplace, it seems to me that the issues come down to these: whether shareholders have adequate ability to ensure the maximum return for their investment consistent with a free market that strengthens our economy and our society. I'd like to elaborate a little about how the oil industry works, and in so doing address the questions of shareholder value and economic performance.

LONG-TERM NATURE OF OIL INDUSTRY

The petroleum industry is a high-risk, capital intensive, long-term business. It has been that way since the industry began more than 100 years ago. Our objective then and now is to deploy our assets to make available to the consuming public the energy resources demanded at reasonable prices. Success requires that companies replace the energy reserves that are produced; and to do this requires sound strategic planning that emphasizes consistent allocations of large amounts of capital to exploration, development as well as to downstream segments of operations. This long-term, consistent approach is the primary reason the industry has, and if fol-

lowed, will continue to provide the U.S. with the energy at reasonable prices to the end consumer.

The petroleum business is not like other businesses. Due to the business risks and significant capital and long lead time required to explore, develop and complete a project, the industry relies on the cash flow from current operating projects and not debt to fund the majority of new petroleum resources. Accordingly, equity funding is normally a much higher part of an oil company's capital structure when compared to most other industries. This situation makes petroleum companies susceptible to unfriendly takeovers where the acquirers are not interested in, or concerned about the long-term well-being of a company or the consumer.

Hostile takeover activities which are funded by debt to be serviced by the existing petroleum company operations, necessitates a significant change in the company's, and ultimately the industry's, long-term plans to replace reserves at a competitive price. For example, Phillips Petroleum's long-term plans, which look out 10–15 years, have been to at least find and develop new reserves which replace current-year oil and gas production. We have also been committed to further develop our leading position in natural gas liquids production, improve our downstream position, further develop our chemical business line, and finance our energy research efforts.

As a result of the takeover activity, our long-term plans have been changed to provide more immediate payout to shareholders versus the traditional balance of current return and long-term investment performance. Increased amounts of current cash flow and proceeds from asset sales must be redirected to debt service in lieu of longer term investment opportunities. This will result in Phillips being a smaller company whose long-term objectives must be reduced with respect to replacement of produced reserves and further development of our natural gas liquids, downstream and chemical business lines, as well as long-term research programs.

PUBLIC POLICY IMPLICATIONS

From the standpoint of public policy on U.S. economic viability, I believe this country and indeed the free world have a long-term strategic and vested interest in the continuing profitable performance of private oil companies. Over the short term, these companies find the oil and gas reserves to replace those which are produced. Domestically, Phillips has been very successful in replacing reserves. One example of our recent activity is our discovery, with Chevron Corp., of the Point Arguello field off California, which may be the largest oil find in the U.S. since Prudhoe Bay in 1968. Internationally, U.S. oil companies have engaged in a substantial effort to find and develop oil resources outside the control of OPEC countries. U.S. oil companies have been instrumental in finding oil throughout the world, and this has been a benefit to Americans. Phillips, in fact, was one of the pioneers in this effort, finding oil offshore Norway in the late 1960s and later developing major fields off Great Britain. We are now also on the leading edge of offshore exploration in China.

Corporate raiders engaged in hostile attempts to take over oil companies are anxious to justify their predatory tactics by arguing that they only have the best interests of the shareholders at heart. They claim that company management has not maximized shareholder value which the attack is geared to do. While this argument is often made, it is rarely challenged. In fact, there is evidence which indicates that, in reality, the problem is not that corporate management has not maximized value; rather, that it is surprising that management has been able to do as well as it has, given the alliance of OPEC, corporate raiders and the effect of certain U.S. government policies, arrayed against the industry.

Oil companies are faced with several real barriers in their business. These barriers take many forms. First, OPEC countries in the Persian Gulf prevent private companies from exploring in their countries which are the principal sources of geologically interesting, low production-cost reserves. As a result, private companies are forced to look for oil in higher cost frontier areas offshore, and in more remote onshore areas.

In addition, private companies are engaged in competition with state-owned oil companies which are able to exploit cheap reserves and substantial government backing, allowing them to aggressively integrate their operations on a worldwide basis.

Governments impose high marginal tax rates on oil companies. Since 1980, a sample of oil companies followed by the American Petroleum Institute has paid 43 percent of its pretax income to the federal government. By contrast, 100 non-oil industrial companies paid only 24 percent of pretax income in taxes. The industry tax burden is even larger when we consider outer continental shelf bonuses and royal-

ties paid. In addition, the oil industry is the only industry subject to a windfall profits tax and is a substantial contributor to the Superfund tax.

Other government practices, such as leasing restrictions, lease bonus payments, prohibitions on exports of crude oil, and various "buy local" provisions all serve to raise the cost of doing business for the industry. I mention these only as factors that affect the cost of operations that may not be reflected in share price.

Again, a key question that should be addressed today can be quite simply stated as follows: "Is the long-range planning and investment that is required to develop future oil and gas reserves in the best interest of our country's energy security and to the consumers?" If so, which I firmly believe to be the case, then some mechanism must be devised to thwart these raiders from forcing a company to mortgage its future for the benefit of a quick profit. For efficiency purposes, it seems that providing tax incentives for investors to engage in a process that, if carried to an extreme, could result in a liquidation of domestic industries, is a policy which, while serving the bottom lines of stock traders and speculators, margin players and financial manipulators, is certainly not in the strategic and economic interests of the U.S. and other free world countries. Placing a "Going-out-of-business sale" on profitable concerns for short-term gain is not appropriate public policy.

PHILLIPS CONTRIBUTIONS TO TECHNOLOGY AND COMMUNITY

Over the longer term, in addition to searching for and producing the oil and gas needed by this country, private oil companies invest in technology in an effort to continue to meet today's challenges and build for the future. This is becoming particularly important since governments are moving away from support for research, and oil companies are a vital and often the only source of energy research. Phillips, in fact, is an industry leader in research and development. Last year we spent about $125 million for research and development. Some of the areas we've been involved in include research and development in biotechnology, and in particular single cell protein, which can make high protein food supplements, or medicines that correct hormone imbalances and break up blood clots. Another is nuclear fusion.

I could also mention our pioneering work in the area of plastics where Phillips research contributed to the development of synthetic rubber. We have maintained this leadership position and are now involved in the development of synthetic metals which is being used by the defense and aerospace industries.

Over the years, Phillips research has made significant contributions not only to the benefits of the company but also to the advancements of technology. Our reputation as a source of innovative, intellectual activity is unmatched among oil companies. The company has continually financed these activities as a part of its commitment to the future, even though they represent real short-term costs to the company, but yield results in the long-term. Our first patent was filed in 1923, and we've made great strides since then. Phillips Petroleum Company has now obtained more patents than any other company in the oil industry in 13 of the past 15 years, and through 1983 we still had 5,480 active patents in the U.S. As an example of Phillips' accomplishments in research, I'm proud to say that Mr. Marvin Johnson of our Research and Development Division was one of 12 individuals awarded the National Medal of Technology just last week by President Reagan for his work with metals passivation, a process by which more gasoline can be obtained from low-grade crude oil. My point here is simple. Corporate raiders will not advance needed research and development which this country requires. If Phillips Petroleum is liquidated to pay the debt which the corporate raiders have accumulated to make their hostile takeover, then the type of research and development I have cited may not occur and will not bear fruit in the future.

I should also add that corporate raiders do not worry about philanthropic activities that will cease when they liquidate a target company. In our case, over the past ten years Phillips has contributed an estimated $85 million to various organizations and other worthwhile agencies that promote education, culture and the arts, economic development, and revitalization of communities.

By taking this perspective, we have learned that for a company such as Phillips to function and grow depends on the well-being of the citizens and institutions wherever it operates. This conviction carries with it civic, social and ethical responsibilities which we demonstrate partially through contributions.

We feel so strongly about this responsibility that our most recent estimates indicate that on a three-year rolling average, Phillips contributed an estimated 1.5 percent of its U.S. pre-tax net income. This compares with about one percent for all U.S. companies.

In 1984, for example, we contributed in cash and in-kind about $14 million which goes to help the nation as a whole. Our contributions are made in 45 states and the District of Columbia. Institutions and programs which benefit from Phillips philanthropy include education where Phillips has underwritten the production and distribution of the most widely viewed series in American education history; matching contributions to universities where Phillips has a matching gift program in which employees' contributions to college and universities are matched 2 for 1. In 1984, Phillips contributed more than $1.5 million to nearly 500 colleges and universities; and U.S. swimming and U.S. diving where Phillips has sponsored U.S. swimming since 1973 and U.S. diving since 1979. We have commitments to support these programs through 1988 which is longer than any other corporate sponsorship of any olympic program.

I am sure you all remember how successful our U.S. Olympic team performed during the 1984 Olympics. There is no doubt in my mind that a successful hostile takeover of Phillips would lead to an end of these contributions.

IMPACT ON JOBS, TAXES AND RELATED BUSINESSES

I'd like to conclude, Mr. Chairman, by briefly mentioning the loss of jobs and other serious economic consequences that would be brought about by a forced liquidation of Phillips. First of all, the town of Bartlesville, Oklahoma, would be devastated. Phillips employs over 20 percent of the entire population, and many of the town's other businesses rely substantially on Phillips employees and their families for their livelihood. Dave Oakley (has or will) describe(d) the serious consequences to Bartlesville so I won't elaborate further except to point out that job losses would extend beyond just Bartlesville. For example, the current rash of oil industry hostile takeovers has had a very serious impact on the construction industry because of the reduced capital available after the mergers. Most contractors that call on Phillips have had projects cancelled that were either budgeted or in progress for one or more of the companies involved in the recent mergers. Phillips has already cancelled many projects worth hundreds of millions of dollars which were scheduled for construction in 1985. In addition, other construction projects budgeted over the next five years have been cancelled or postponed indefinitely whose costs range in the billions of dollars.

In addition, the breakup of Phillips would affect many independent product marketers across this country because we market 95 percent of our refined products through independent marketers in a 34-state area. Frank Phillips, the founder of our company, was once asked how far he planned to go in petroleum marketing. He responded by saying, "Just as far as that independent retailer will take us." These retailers have taken us a long way. Our independent marketers have gained a large market share in several states—12 percent in Iowa and 9 percent in Colorado, for example.

One only has to use history to determine what might happen to these independents if assets like our refining/marketing are sold to pay off debt. When Texaco and Getty merged, the Getty marketers were spun-off to Powertest and Chevron spun-off the Gulf marketers to Sohio, neither of which use independent dealers to any great extent. As we see it, the net outcome to these independent businessmen would be: loss of business; a less reliable source of supply; loss of brand identity; loss of credit card business; the inability to establish/maintain credit line; and loss of the benefits that a large integrated oil company can offer.

Also, as I mentioned earlier, Phillips is a large taxpayer to local, state, federal and international governments. While I can't say quantitatively exactly how much tax loss would result from the liquidation of Phillips, I'm sure the loss would be felt severely among several states such as Oklahoma. In addition, federal tax revenues and lease payments would drop. I should point out also, that since hostile takeovers are occurring in the oil industry, loss of tax revenues from Phillips is only one example. Other companies directly or indirectly effected by these activities have and will reduce taxes paid to the government.

SUMMARY

In summary, Mr. Chairman, I believe that sound public policy should foster economic growth over the long term. I believe that the free market should be supported and strengthened by the government. A review of the impacts that hostile corporate takeovers have on shareholders, employees, and the communities served by companies is therefore in the national interest.

The critical issue is whether we want to encourage the short-term speculator, out for the quick profit, over the long-term performance of U.S. companies who supply

the services our citizens need at reasonable prices and who offer a climate for growth to shareholders.

This testimony has focused on the costs to the company, its stockholders, employees, communities and the nation, of a hostile takeover of this, or any other profitable company. As a businessman, I am daily concerned with the ledger—scrutinizing costs and benefits. Evaluating a hostile takeover in those terms in which costs and benefits are weighed is no different than any other business decision. I believe that the increasing trend of attempts to take over companies has real direct and large costs to *all* concerned. Most importantly, these costs outweigh the potential and possibly fleeting benefits claimed by the practitioners.

Chairman PICKLE. We thank you, Mr. Douce.

I appreciate the testimony of both of you gentlemen. We are glad that you agreed to appear before us.

I think I will recognize Mr. Jones first, if he would like.

One of the witnesses is from your area. Would you care to proceed?

Mr. JONES. Mr. Chairman, I thank you.

I particularly want to welcome Mr. Bill Douce to the committee and want to thank him for his support of this legislation.

The purpose of these hearings is to find out what is the best way to deal with what I think is a bad practice and aberrant practice as far as the free market system is concerned, without unduly interfering in the free market system.

I might just ask one question. One of my colleagues asked about the definition that we are using for a hostile takeover whether that is the proper definition or whether there be some other standard? He asked the question, for example, what is the difference between a hostile and a friendly takeover.

Would you care to address that portion of the legislation, if you have any thoughts on that?

Mr. DOUCE. My definition of a hostile takeover would be an offer or an effort that is deemed not to be in the best interest of the shareholders by a majority of the independent directors on the board of directors of the corporation in question.

Mr. HARTLEY. May I tell you, sir, that is certainly our definition. If the board of directors in total or the independent outside directors alone comes to the conclusion that the proposal is not in the interest of the company and it is forcing on the company an event which is contrary to the best interest of the company, in the opinion of those directors, then it is a hostile takeover.

Chairman PICKLE. Do either of you gentlemen know—is there any other provision in the code that would allow that kind of definition, allow a given set of directors to decide whether it was a hostile or a friendly takeover?

Mr. DOUCE. Not to my knowledge.

Chairman PICKLE. I can understand how you feel, but now we are trying to find out, is this good tax policy to make such a provision? Is it not in the code at this point? You are giving to a set of directors a right to say, "We don't want this company taken over," and let them make that decision unto themselves. That is a pretty far going proposition.

I don't know that I would say that the Congress might or might not approve of that, but that is a problem, as I see it.

Mr. DOUCE. I can understand your concern, Mr. Chairman, but the responsibility of a director on the board of a major corporation

is substantial. If they are independent directors, and they come to the conclusion that the offer is not in the best interest of the shareholders, I have a hard time determining any better index, gauge or measure of what constitutes a hostile takeover.

Chairman PICKLE. I want to ask Mr. Hartley, and I think I know your answer on it: Do you feel that the tax laws encourage mergers? Do you think our present tax laws encourage them?

Mr. HARTLEY. Well, certainly—let's take the case that Mr. Pickens faces right now tonight. He and his group have borrowed something approaching a billion dollars. He has been able to pick that money up off of a consortium of about seven or eight banks at prime rate plus a half. That's is 11 percent. Eleven percent of that billion is $110 million a year interest.

We do pay a dividend. After netting out the dividends that he will receive on those borrowings, he will on an after-tax basis have to dig up something in the area of $42 million.

If those interest payments were not deductible, he would have to dig up $84 million a year to carry his stock. Obviously, as Mr. Edgar Bronfman stated in my testimony that I quoted from——

Chairman PICKLE. Yes, I noticed you quoted Mr. Bronfman.

Mr. HARTLEY [continuing]. That would certainly slow him down.

The same, of course, would apply to the interest paid on the junk bonds, which incidentally go at interest rates, sir, rarely below 16 percent—typically, 16 to 19 percent. That is why they are called junk, because they pay high interest because they are not of investment quality and banks are not allowed to buy them.

Chairman PICKLE. How can they be sold at 16, at 2 or 3 percent above the normal rate?

Mr. HARTLEY. Why can they be?

Chairman PICKLE. Yes.

Mr. HARTLEY. Well, because we've got such things as investment groups in this country. They take many forms: Money fund managers, pension fund managers, insurance companies. I have seen recently—in fact, in the past 24 hours—the list of all the companies, so-called investment houses of one kind or another, financial institutions, who are buying these junk bonds, and you wouldn't believe the list.

They are doing it because they are greedy and they want that money, and they are financially strong, as a very large insurance company, for example, so they are willing to take the risk on that particular piece of paper. They can bury it into their total activity if they make a mistake. Of course, it means that insurance premiums go up to their insurance people, if they lose money on their investments, lose their principal, and so on.

Chairman PICKLE. Excuse me, Mr. Jones. I didn't mean to interrupt you.

Mr. HARTLEY. The savings and loans buy those bonds because they really have nothing to lose because this good Government of ours guarantees those broker deposit accounts that they have for $100,000. So if they make a mistake, so they go broke; so Uncle Sam pays it off the depositors, and another investment institution goes down the tube.

You have seen a lot of that going on in this country in the past 2 to 3 weeks: banks laundering Mafia money, banks loaning to their

directors and negotiating bad loans with them. You have seen the savings and loans in Ohio. I would think by now there ought to be some reason in this world for this Congress to decide that enough is enough and it is time we got the United States back on some solid ground that you and I took for granted.

We never even thought about problems of this kind in the past. These problems have all been brought to you and to me as a result of these pirates. We call them the pious piranhas.

Mr. JONES. Mr. Chairman, let me ask Mr. Douce to clarify what the nature of the Mesa Partners is.

If we are going to get into this, we need to look at some case studies. Obviously, one case study is the Mesa Partners and the Phillips takeover attempt. Mr. Pickens says that the attempt was—the borrowing of the money to take over Phillips was backed by Mesa Petroleum assets. Yet, if I remember correctly, he or his people told the FTC that they were exempt from antitrust regulations because it wasn't Mesa Petroleum; it was Mesa Partners which had assets of less than $10 million.

Can you clarify that issue?

Mr. DOUCE. I will be glad to try, Congressman.

If you are looking for a case study, we can sure give you one in this whole area of takeovers after dealing with Mr. Pickens and then later with Mr. Icahn.

I am testifying tomorrow morning before the Monopolies and Commercial Law Subcommittee of the House Judiciary Committee, and I plan to comment on the points you have raised.

A second set of problems related to takeovers is involved in the point you have brought up, where the raiders establish a shell or bogus partnership to pursue their takeovers.

The goal of such partnerships appears to be to circumvent the objective of the Hart-Scott-Rodino Act public disclosure requirements and to mislead Federal agencies as to the true intent of the raiders' activities.

Apparently, the Federal Trade Commission's current interpretation of the law, and its own regulations, is that a partnership is not required to report accumulations of a corporation's shares. This appears to be the case even if a partnership is formed for the purpose of avoiding the reporting requirement of the Hart-Scott-Rodino Act.

In the case of the Pickens move on Phillips, we feel that Mesa partners was formed to take advantage of what appears to be a loophole in the regulations of the FTC.

Chairman PICKLE. Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman. I appreciate that.

Some of the main issues here involved in mergers and acquisitions are the varying interests of the shareholder and management, a difference of opinion as to what they think the company ought to be doing. The shareholders have a tendency in most of these cases, by their action, of favoring the takeover, and management in some cases, certainly in hostile areas, does not.

I wonder, Mr. Hartley, if you would elaborate a little bit on these two interests. Since Mr. Jones mentioned hostile takeovers and in your definition a hostile takeover exists when the outside director opposes the takeover attempt. What do you do when there is a dif-

ference of opinion between that outside director, and management, and the stockholders? What should Government's policy be?

Mr. HARTLEY. Well, the outside directors in our case are a majority of the directors. The inside directors are a minority. Just like in Congress, the majority is the winner.

Mr. FLIPPO. Yes; but I mean now the stockholders of your company, when their interest appears to be different from what your outside director wants to do——

Mr. HARTLEY. I think you are making an assumption on the interests of the outside shareholders. If you are talking about Mr. Pickens, and Mr. Icahn, and all of that clan, all of the fast-buck boys, they have no interest in our shareholders whatsoever. What they have an interest in is a technique——

Mr. FLIPPO. Yes.

Mr. HARTLEY [continuing]. And that technique puts the company in play first by using hard assets to borrow the first percentage of shares. That was what happened in our case, up to a total—they had enough money lined up for seven banks. The assets that they had were valued by the appraisers of those banks, those oil properties, their reserves, their production rates, all of the factors, that caused them to grant those companies, owners of those properties, loans which totaled approximately $1.2 billion. That money, then, was pushed into the Mesa II partnership by the companies: Brown & Wagner Co., and Mesa Co.

Mr. FLIPPO. Yes.

Mr. HARTLEY. And then that gave them their first move to ownership. Their next move, obviously, is to get additional monies from the banks by using the shares already on deposit in Mesa II——

Mr. FLIPPO. Yes, sir. May I——

Mr. HARTLEY [continuing]. And buy on margin.

Mr. FLIPPO. May I ask you to give us the benefit of your experience? I believe Unocal has been involved in some mergers in the past. I wonder if you might give us your experience there over the past 20 years.

Today we permit, and then we permitted, an interest deduction involved in those mergers. If you had not had the interest deduction, would you have gone ahead with the mergers that you have concluded over the past 20 years?

Mr. HARTLEY. Well, most of the mergers that we have made—we haven't made very many—first, there has never been an unfriendly one. We think that, if you are in business, you are supposed to have the manners and morals, ethics and integrity.

Mr. FLIPPO. Yes, sir.

Mr. HARTLEY. It does not occur to our minds, to run around, in effect, picking on somebody else's company. We put it in the same category as deciding you want to pick on the other guy's wife.

Mr. FLIPPO. Yes, sir, I understand.

Mr. HARTLEY. Now going back to the case again of yours, we have issued our stock in some cases so that there was a stock exchange made at a negotiated exchange rate between the two managements of the company and, where necessary, approved by the shareholders.

Mr. FLIPPO. Mr. Hartley, I take it—since my time is limited, perhaps I could ask you to submit a response for the record, so that we could have that history included in our record.

[The following was subsequently received:]

Union Oil Company of California (Unocal) has participated in two mergers in the past twenty years, one with the Pure Oil Company, and one with Molycorp. Both were carried out through stock transfers and transactions, so there were no tax implications such as for borrowed funds as is the subject of the question here.

Mr. HARTLEY. There is only one other large case. That was the case we took on Molycorp Co. The second case was the Pure Oil Co., where we issued preferred stock.

Mr. DOUCE. Congressman Flippo, may I answer that question?

Mr. FLIPPO. Yes.

Mr. DOUCE. We had an acquisition or a merger last year of $2 billion, and we had one the year before of $1 billion. You asked, would we have made those if the interest had not been deductible on the borrowed money?

Mr. FLIPPO. Yes.

Mr. DOUCE. My answer to you is we probably would, but we probably would have paid a lower price.

Mr. FLIPPO. I see.

May I ask, since we are talking about Phillips in this case and trying to understand a little better what happens—I believe Phillips paid to Mr. Pickens some funds for the return of the stock. You acquired Mr. Pickens' stock back.

Mr. DOUCE. We paid him $53 a share; right.

Mr. FLIPPO. That was a cash price?

Mr. DOUCE. Right.

Mr. FLIPPO. Did any other stockholders of Phillips get a cash price for their stock at that price?

Mr. DOUCE. No, sir.

Mr. FLIPPO. I wonder if you could tell me whether or not Phillips deducted the entire payment to Mr. Pickens or does Phillips intend to deduct the entire payment to Mr. Pickens for the return of that stock?

I see you have your tax counsel there, if he would like to reply to that.

Does Phillips intend to deduct—what do you do with that treasury stock? Do you bring it back on the books at market or do you deduct the whole thing?

Mr. O'TOOLE. Our plan is not to deduct that cost.

Mr. FLIPPO. None?

Mr. O'TOOLE. We are aware that there is a case, an old case, that might support deducting the cost, but we think that it is not applicable to our situation.

Mr. FLIPPO. I see. So you would then bring it back on the books at market value?

Mr. O'TOOLE. Right.

Mr. FLIPPO. At your cost, at what you paid for it. I see. That's important.

Mr. Chairman, I see my time has expired. I have many more questions of these witnesses.

Chairman PICKLE. Did you say, when you made a settlement with Mr. Pickens, that you paid him off in cash?

Mr. DOUCE. Yes, sir.

Chairman PICKLE. Did you pay other stockholders off in cash?

Mr. DOUCE. No, sir.

Chairman PICKLE. Why? What was the difference?

Mr. DOUCE. That was part of the agreement we negotiated with Mr. Pickens.

Chairman PICKLE. Why did you reach that agreement with him?

Mr. DOUCE. Mr. Pickens requested that we pay him in cash.

Chairman PICKLE. Do you know why he wanted it in cash?

Mr. DOUCE. We wanted Mr. Pickens to cease being a shareholder in our company. He made that a condition of the agreement.

Chairman PICKLE. Is that greenmail?

Mr. DOUCE. That is not greenmail. The value to every other shareholder was also $53, as best we could judge.

Chairman PICKLE. That is why both Mr. Pickens and you said that it wasn't greenmail, but you paid him off in cash and you didn't pay the other shareholders the same way?

Mr. DOUCE. That's right.

Chairman PICKLE. You are saying that you are not going to deduct that interest?

Mr. O'TOOLE. That's correct.

Chairman PICKLE. Go ahead. Were you through completely?

Mr. FLIPPO. My time has expired, and I appreciate very much the testimony of the witnesses. Thank you.

Chairman PICKLE. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

I am still having some trouble with the definition of friendly versus hostile. I guess one definition is yours, Mr. Douce, that a majority of the outside members of the board would agree on a vote of the board that it would be hostile; that would be one thing.

I thought I gleaned from your testimony, also, that a definition included in my colleague Jim Jones' bill that hostile would be something that would be financed through junk bonds. I am not sure whether or not—is that part of the bill, Jim? I yield to you.

Mr. JONES. Hostile would be defined as when a majority of the outside independent directors termed it hostile.

Mr. MCGRATH. What about the financing?

Mr. JONES. The financing of junk bonds is what we are trying to get at, what we are questioning.

Mr. MCGRATH. I guess my question is, do both have to be there in order to be hostile?

Mr. JONES. That's right.

The only thing we are going after in a hostile takeover is the financing of that hostile takeover by junk bonds.

Mr. MCGRATH. I understand that.

Mr. Hartley is quoted in the Washington Post today as saying that he is asking the subcommittee to consider the end of deductions on interest costs on money borrowed for hostile takeovers. Friendly takeovers, it would be all right?

Mr. HARTLEY. That is a newspaper report.

Mr. MCGRATH. We should treat——

Mr. HARTLEY. Don't think of that newspaper report—we are not getting into the kind of definition we get here, but whether I——

Mr. MCGRATH. Let me ask you the question directly then: should we be treating the deductibility of interest on funds borrowed for hostile takeovers differently than we should in friendly takeovers?

Mr. HARTLEY. That is a very good question. I think that should be given a lot of thought.

There is no question in my mind on the hostile takeovers, the interest paid banks, the interest paid savings and loans should not be deductible for tax purposes.

Mr. MCGRATH. If we take that answer to its logical conclusion, and your company wanted to reduce its tax liability by recapitalizing through debt, maybe that debt should also be nondeductible.

Mr. HARTLEY. Well, you know, there is a lot of money manipulation going on. That's why, of course, my first recommendation to this committee is to have a moratorium in this whole area to see if we can get some sense into this economic system of ours which has degraded itself to the point where, as the man stated in the Post article, the whole thing is getting to be a disgrace, because it is using funds for nonproductive purposes. It is using funds for the destruction of viable companies.

Mr. MCGRATH. Let me just ask—I think Phillips has answered already. I understand greenmail as a payment to an individual or a group that you would not pay to your ordinary stockholders. You say that you are not going to deduct as an ordinary business expense that payment, whether it be the entire payment or the differential between the market value and the actual payment. Am I correct?

Mr. O'TOOLE. Right. In our case, we don't see a differential. We are saying that both parties are getting the same.

Mr. MCGRATH. Exactly.

Mr. O'TOOLE. There is no issue.

Mr. MCGRATH. What about you, Mr. Hartley? How do you feel about the deductibility of greenmail payments by the target company?

Mr. HARTLEY. Well, we are not, of course, at the——

Mr. MCGRATH. You are not at that point yet.

Mr. HARTLEY. We are not at the greenmail stage. To answer your question very specifically, we would hope that this committee would see its wisdom to—if you were to ask me my opinion, I would confiscate the entire amount over and above the price the fellow paid for it.

Mr. MCGRATH. Mr. Pickens in his——

Mr. HARTLEY. You probably cannot do that, so at least you will make certain that it is taxed at normal income tax rates.

Mr. MCGRATH. Mr. Pickens in his testimony this afternoon said that corporations just ought to vote that they are not going to pay any greenmail, and that would end that. How about you? Do you agree with this——

Mr. HARTLEY. That is a propaganda position on his part. He doesn't care whether you—he has his technique worked out so well that it doesn't have to be green. He has it worked out so that he gets himself in a position putting a company into play that he gets a lot more than just greenmail.

In the Gulf case, he greened it up all the way to $80 a share from his own bid price of only $65 a share, which he stated this after-

noon, if you remember. He got the same price as everybody else, but that price got there because of the fact he made Gulf a target company. He forced the destruction of that company.

Management didn't know what else to do. I could be facing that same issue, but I am fighting this issue, because I don't think Union Oil of California should be destroyed by a pious piranha.

Mr. MCGRATH. Mr. Chairman, I see my time is up. I yield back whatever time I have left.

Mr. DOUCE. Congressman McGrath, may I go back to one of your questions?

Mr. MCGRATH. Certainly.

Mr. DOUCE. You raised a question about the deductibility of interest in friendly deals versus hostile deals. That would apply to where you substitute debt for equity.

I think we are probably a step or two further down this road than Mr. Hartley and Unocal. Our position, as stated in our paper, is that our concern on the deductibility is only for money for financing a hostile takeover attempt.

Mr. HARTLEY. I would like to correct my statement.

Mr. MCGRATH. I guess my question is, what the definition might be as opposed to what you consider it to be, and whether or not the difference between hostile and friendly is just money.

Mr. HARTLEY. Is what?

Mr. MCGRATH. Is just money, price. I don't think any—I'm not sure, perhaps I would make an off-the-cuff statement that most takeovers begin as hostile and, as they get worked out, they become more friendly. The difference is simply price.

Mr. DOUCE. I think if you look around at all of industry that there are a lot of takeovers that do originate on a friendly basis. They are not all hostile.

But when you determine whether it is hostile, it is determined by your outside directors. In our case, we have 11 outside directors out of a total of 16. They evaluate offers from the shareholders' standpoint, and you look at all the responsibilities. You look at the price that your shareholders will receive. You look at the obligations that the company has to its employees, to employees' families, to the communities, to the customers, and to their suppliers. All those things are evaluated by this outside board. If they determine that it is not a fair offer to the shareholders, then it becomes hostile.

In our case we have had two great examples of it.

Mr. FLIPPO. Would the gentleman yield?

Mr. MCGRATH. Yes.

Mr. FLIPPO. I wonder if you could elaborate. What is the responsibility of management to the stockholder, even the outside director? Is it to manage? What I am really trying to understand here is the difference. What is the economic difference between a hostile takeover and a friendly takeover? Is it the amount of debt that is involved, the debt-to-equity ratio? What are the essential characteristics? What does an outside director evaluate when he is trying to evaluate on behalf of the stockholder? Cannot the stockholder make that evaluation himself? It is his money.

What does he do? What does he look at? What are the factors that the outside director looks at when he decides if this is a hostile takeover or not?

Mr. DOUCE. He looks at the price that has been offered per share to the shareholders. If you are a large public corporation, it is difficult for the shareholders to speak for themselves. That is what the board, and particularly the independent directors are for.

Then the board looks at secondary considerations. In today's world it is not always just entirely a matter of price. These secondary considerations include the impacts to the employees, to their families, and to the communities. All of those things are evaluated. If the board feels that it is not in the best interest of the shareholders, and the primary consideration is economic, then the offer becomes hostile.

Mr. FLIPPO. Well, I guess I just figure that, if it is my money in there, I would like to have the right to make that decision rather than to have some outside director make it for me. I would guess that would be the way I would feel about it.

Thank you very much.

Mr. HARTLEY. Congressman, I would like to comment on that.

Mr. FLIPPO. Yes, sir.

Mr. HARTLEY. In our cases, and other cases I observed, being subject to a hostile takeover, is quite different from a situation in which somebody makes a total tender with hard cash for the entire company. In the second case—a tender for the entire company—the board of directors has to have very good reason for not permitting the shareholders to make that decision as to whether they will accept it.

There have been many legal cases on the point of whether or not the amount is insufficient. Incidentally, in those cases you always use outside independent talent who put their necks on the line to evaluate whether that tender offer is or is not adequate.

Those facts are put in the hands of all directors, including the outside directors. A recommendation to not accept that tender can be made to the board. If the board wishes to stand on that, they can, but typically they would organize for a stockholder vote. The shareholders can then accept it or reject it on the basis of the analysis that is put together.

Now on the hostile takeover situation, we are not talking about the company being taken over. We are talking about a company having—as I like to say, sir, without being too dramatic with you—the blood of equity extracted and replaced with the cold, corrosive, chilling water of debt. Having gotten that equity out, they then will scatter it around, taking a heck of a lot of it for themselves and lesser amounts to the stockholders.

In order to consummate that financial deal, they then, as Mr. Douce has already stated, have to liquidate that company in order to retire that debt, because at that point the debt content of the company is so high and the interest payments of that debt are so high that the company cannot survive. It, in effect, is put into a kind of bankruptcy. It has to liquidate itself.

That is, of course, where the risk goes to the savings and loans, because it could well be that they cannot liquidate it at the value they put upon it. That is what a hostile takeover is all about.

It is easy to define. It is not difficult at all, at least not to my mind.

Mr. FLIPPO. Well, I know you have managed well for a number of years in what you consider the best interest of your stockholders, Mr. Hartley.

Thank you.

Chairman PICKLE. We must move on to the next panel, but let me ask Mr. Douce real quickly—before you were a target or before you were troubled, your company, what was the value of your stock? Phillips?

Mr. DOUCE. I would say it was around $38 to $40.

Chairman PICKLE. Thirty-eight to 40. What is the value of your stock now?

Mr. DOUCE. It is about $38, $39.

Chairman PICKLE. So you haven't gone up in the overall value of the stock? It has been much the same?

Mr. DOUCE. Half of our stock has been retired, Mr. Chairman, at $52 per share.

Chairman PICKLE. Yes, yes. But what is left is at $38.

What was your debt-to-equity ratio before? Can you give me that figure now?

Mr. DOUCE. It was about 25.

Joe, do you remember?

Chairman PICKLE. About what?

Mr. O'TOOLE. Twenty-five to 30.

Mr. DOUCE. Twenty-five to 30 percent debt-equity.

Chairman PICKLE. All right, 25 debt-equity.

What is it now?

Mr. DOUCE. It is about 80.

Chairman PICKLE. Were you paying Federal income taxes before all this started?

Mr. DOUCE. You bet.

Chairman PICKLE. Are you paying Federal taxes now?

Mr. DOUCE. Yes, sir.

Chairman PICKLE. As much or less?

Mr. DOUCE. It will be less now.

Chairman PICKLE. Why will it be less?

Mr. DOUCE. Because we have replaced $4.5 billion of equity in our company with $4.5 billion worth of debt.

Chairman PICKLE. Can you give me some idea, why was your stock undervalued, or do you say that it was undervalued?

Mr. DOUCE. Our stock was in about the same condition as all of the stocks in the oil industry, Mr. Chairman. They all were selling at about 50 percent of their appraised value, as a rough approximation. We weren't any different than most other oil companies.

One of the reasons for that level of market price as compared to appraised value is the nature of the oil industry. We are both a short-term and a long-term industry. It takes huge sums of money on a long-term basis to find oil and then to develop it.

Consequently, the market prices are substantially lower than the appraised value.

Chairman PICKLE. Mr. Hartley, what is the value of your stock now?

Mr. HARTLEY. Today it is about $49. I didn't see the close of the stock market today, sir, but it closed yesterday at about $49 and a half.

Chairman PICKLE. Forty-nine?

Mr. HARTLEY. Yes; and before all of this attack started, it was trading in the area of $35 to $37 a share. That takes us back, sir, to about the last week in December. Now all this has happened in that very, very short time period.

Chairman PICKLE. Are you paying Federal taxes now, your company? Are you a successful company?

Mr. HARTLEY. I don't know whether you were here when I read off our tax payments or not, sir.

Chairman PICKLE. No, I was not. I missed that part.

Mr. HARTLEY. I have them for you. I'll summarize. I have it by years: 1982, 1983, and 1984.

Chairman PICKLE. Just give me the totals.

Mr. HARTLEY. The summary in those 3 years, we paid the Federal and State governments about $1 billion in taxes. On a worldwide basis, we paid to governments, including our own, about $1½ billion.

Yes, we pay taxes.

Chairman PICKLE. Well, we thank you, gentlemen.

Mr. HARTLEY. I would like, sir, to make another comment, if I may.

Chairman PICKLE. All right, sir, Mr. Hartley.

Mr. HARTLEY. The question here of why are companies undervalued on the stock market—it is the same reason that most living things are worth less alive than they are dead, including, unfortunately, you and me—because we carry insurance. You can't get at that dough until you pass on. Of course, you can't get at it any more than I can, either.

It illustrates the point that there are values in a company that give that company continuity. In other words, sir, if a company only had 1 year of oil reserves, and that means that you would pump out enough barrels per day so that at the end of that year there would be no reserves left, that would be the end of that company—finished.

We oil men have the job of giving that company continuity. Typically, in America today I think the years of reserves behind our pumping rates is somewhere between 5 and 10 years; in natural gas I think it is higher than that, 8 to 13 years.

That gives a company stability. Incidentally, sir, it allows those people that we serve to know that they can rely upon us as a reliable source of energy. I would think that is pretty important to every citizen.

Chairman PICKLE. Yes, sir.

Mr. HARTLEY. Let's just look at the book value, the market value, of the following companies: the John S. Herold appraised value of those companies that have gotten all involved in big mergers and have ended up with tremendous debt:

Chevron has a Herold appraised value of $37 billion. They have just taken on Gulf and added about $13 billion in debt to that company. The market value of that company on the 25th of February was only $12 billion. That's 33 percent of Herold's appraised value.

Texaco, $24 billion, Herold's; market, $9 billion; another 33 percent.

Mobil, $36 billion appraisal; market value, $12 billion; another 33 percent.

Now is it reasonable to think that if that is what the appraised value—that is what the market value is versus the appraised value—that somebody should now decide that all of those companies are poorly managed and they all ought to be raided and destroyed, as the companies were that they took over and have merged into? Of course not.

I think that would tell you, sir, that something is really pretty goofy going on here in this whole question of taking a position that, if a stock isn't trading at Herold's appraised value, then the company is poorly managed. I tell you, sir, that is a phony.

When Mr. Pickens tells us that his stock is selling at that, it is because of the fact he is really not in the oil business; he is in the securities business. He has set up a record of being able to get out of the hides of companies cash to his company which has causd his company to have a value based on its security business, and his track record, which God knows is very good.

Chairman PICKLE. Well, Mr. Hartley, I can certainly understand your deep feelings. Obviously, you are sincere about the problem you face.

We are holding these hearings to try to understand the problem. We recognize that takeovers are the hottest game in town now, and we are trying to understand them and trying to ascertain, is there something we can do about it.

Like you, I think there is a chipmunk in the woodpile somewhere or this wouldn't be going on.

However, what we can do about it and how we approach it is our problem. We recognize that.

We thank both of you gentlemen for your testimony.

[The following was subsequently received:]

UNION OIL CO. OF CALIFORNIA,
Washington, DC, May 13, 1985.

CHARLES RANGEL,
Chairman, Subcommittee on Select Revenue Measures, Longworth Building, Washington, DC.

J.J. PICKLE,
Chairman, Subcommittee on Oversight, House Ways and Means Committee, Longworth Building, Washington, DC.

DEAR CONGRESSMEN PICKLE AND RANGEL: On April 2, 1985, Unocal testified at the joint subcommittee hearing on the tax aspects of acquisitions and mergers. We would appreciate your incorporating in the record as supplemental testimony the enclosed letter to Senator Riegle which deals with some important additional topics relevant to the scope of the subcommittee hearings.

Sincerely yours,

E. WILLIAM COLE, *Vice President.*

Enclosure.

UNION OIL CO. OF CALIFORNIA,
Washington, DC, May 10, 1985.

DONALD W. RIEGLE, Jr.,
U. S. Senate, Committee on Banking, Housing and Urban Affairs, Washington, DC.

DEAR SENATOR RIEGLE: Unocal testified at the hearing on April 3, 1985 before the Committee on Banking, Housing, and Urban Affairs which was called to examine whether the recent increase in corporate mergers is in the best interest of American

industry. You were not able to ask all your questions in the allotted time and, therefore, requested witnesses to respond to certain additional written questions. By letter dated April 17, 1985, we were asked to answer the following question for the record:

Senator Riegle: Is our tax system neutral with respect to hostile takeovers, leveraged buyouts and break-up liquidations or does it in fact encourage or discourage that activity?

INTRODUCTION

Speaking from the experience of a company that is in the midst of defending itself from a hostile takeover attempt by Mesa Petroleum Co. ("Mesa"), Unocal believes that the tax system encourages hostile takeover activity and that corrective legislation is necessary.

The clearest example of the subsidization of hostile merger activity is the deductibility of interest on both the bank loans and junk bonds that finance such activity. Tax assistance such as the deductibility of interest as an expense is warranted to build the economy but is indefensible in connection with hostile takeovers which have such a destructive effect on our economy.

There has already been much debate on the impact of the interest deduction on hostile mergers. However, there are other more subtle and technical tax gimmicks that have not been adequately scrutinized. Utilizing these gimmicks, raiders may claim capital gains on sales that should be taxed as ordinary income, use the installment sale method to obtain an interest free loan from the government on transactions that should be immediately taxable and deduct expenses that should be capitalized.

Because of the Mesa raid against Unocal, we have examined previous Mesa transactions in an attempt to discover how the tax laws may have facilitated those transactions. As a case in point, we have reviewed Mesa's attempted takeover of Gulf in 1983 and its sale of Gulf stock in 1984 at a reported profit of over $400 million.

It is not known whether Mesa has filed its return for 1984 in connection with the Gulf transaction or, if so, what position it has taken on its return. However, the issues are significant enough to require intense IRS examination when Mesa returns are audited (IRS has not yet examined Mesa's returns for years after 1980) and may require corrective tax legislation to prevent manipulation and abuse by corporate raiders in the future.

THE GULF TRANSACTION

During August through September, 1983 Mesa acquired an aggregate of 8,200,000 shares of Gulf common stock in transactions on national stock exchanges. [1] On September 30, 1983, Mesa transferred such shares to Mesa Asset Co., a wholly-owned subsidiary of Mesa, which was incorporated on September 26, 1983. On October 5, 1983, Mesa Asset sold a portion of its Gulf shares to other entities in the investor group and between October 5 and October 14, 1983 the investor group, including Mesa Asset, acquired additional Gulf shares. On October 14, 1983, Mesa Asset transferred its remaining Gulf shares to Mesa Offshore Co., a wholly-owned subsidiary of Mesa, which was incorporated on January 3, 1972. Mesa Offshore was a shell corporation whose only assets consisted of the Gulf shares and $1,000 of cash or cash equivalents.

On February 23, 1984, Mesa and other members of its investor's group commenced a tender offer for up to 13,500,000 shares of Gulf at $65 per share. On February 24, 1984 the Gulf Board of Directors determined that the offer was unfair and inadequate and recommended that the Gulf stockholders reject the Mesa offer.

Thereafter, Gulf began looking for a white knight to save it from the Mesa offer. Standard Oil of California ("SoCal") won the bidding for Gulf with a tender offer on March 7, 1984 to acquire all the outstanding shares of Gulf for $80 a share. The tender offer was made pursuant to a merger agreement dated as of March 5, 1984 among SoCal, a SoCal subsidiary and Gulf. The merger agreement provided that the SoCal subsidiary would be merged with Gulf and each outstanding share, other than shares held by SoCal and by stockholders exercising appraisal rights, would be converted into a right to receive $80 in cash. The merger was effected on June 15, 1984.

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[1] This description of the transaction is based primarily on Schedules 13D dated October 5, 1983 and June 13, 1984 (Amendment No. 38) filed with respect to Gulf by various Mesa companies and on Schedule 14D-1 filed by SoCal on March 7, 1984 and Schedule 13D (Amendment No. 3) dated June 15, 1984 and filed by SoCal with respect to Gulf.

Immediately before the SoCal/Gulf merger, Mesa, on June 13, 1984, sold all of the shares of Mesa Offshore (which then owned 14,467,458 Gulf shares) to a whgldy%owned subsidiary of Penn Central for $1.1 billion. Penn Central had provided financial backing for Mesa's attempt to take over Gulf. Although the transaction was structured as a sale of Mesa Offshore stock, the stock purchase agreement contemplated that Penn Central might file a "section 338 election." That election would allow Penn Central to treat the transaction as if it purchased the assets of Mesa Offshore (i.e., the Gulf shares) so that it could obtain a step-up*.....END OF BAD MAG TAPE BLOCK* in basis for the acquired Gulf shares equal to the price paid for the Mesa Offshore stock.

The consideration paid by Penn Central consisted of Penn Central's return of subordinated notes, preferred stock and warrants that had been issued by Mesa to Penn Central for $300 million in February 1984, $12 million in cash and a five-year installment note in the principal amount of $796 million. Mesa's 1984 Annual Report states that the sale resulted in approximately $404 million of pretax gain to Mesa. [2]

The stock purchase agreement dated June 13, 1984 among Mesa, Penn Central and the Penn Central subsidiary contemplated that the Gulf shares owned by Mesa Offshore would be sold by Penn Central pursuant to the SoCal/Gulf merger agreement. On June 21, 1984 (just eight days after its purchase of Mesa Offshore) the Penn Central subsidiary sold the Gulf shares held by Mesa Offshore to SoCal for approximately $1.16 billion in cash. [3]

The Mesa sale to Penn Central appears to have been arranged with a careful eye to the tax laws and raises a number of questions as to how the tax laws should be interpreted.

CAPITAL GAINS

As one commentator noted in a recent article, corporate raiders often claim preferential long-term capital gains treatment for their raiding gains.

"Long-term capital gains treatment may be claimed even if the hostile bidder has not held the stock for more than the six-month holding period. For example, a hostile bidder having a shell subsidiary corporation that is more than six months old could have that subsidiary purchase the target's stock with new money contributed to the subsidiary. The hostile bidder could then sell the subsidiary's stock to the target company in exchange for the greenmail payment, and take a long-term capital gain on the sale of the subsidiary's stock." [4]

According to contemporaneous newspaper accounts, Mesa used its shell corporation, Mesa Offshore, in an attempt to turn short-term capital gain into long-term capital gain. The New York Times reported one analyst's conclusion that Mesa would pay $130 million less in taxes because the transaction was structured to obtain long-term capital gains treatment. [5]

It appears questionable whether the sale of Gulf stock would qualify for long-term capital gains treatment at a 28 percent rate (as opposed to short-term gains treatment or ordinary income treatment at the top corporate rate of 46 percent).

First, assuming the Gulf shares were contributed to Mesa Offshore in a tax-free exchange, the Mesa Offshore shares arguably would have the same holding period as the Gulf stock contributed to Mesa Offshore. [6] Since the Gulf stock was not held for the long-term capital gains holding period of one year, the Mesa Offshore stock also would be deemed not to have been held for the one-year period. [7]

Second, the Internal Revenue Service could assert that the substance of the transaction was really Mesa's sale of Gulf stock, rather than the sale of stock of its shell subsidiary. Under this theory, long-term capital gains treatment also would not be available since the Gulf stock was not held for the one-year holding period.

Third, if the transaction is treated as the sale of Mesa Offshore stock, the Service could take the position that Mesa Offshore is a collapsible corporation so that the entire gain is ordinary income under IRC § 341. Generally, for § 341 to apply, the Gulf stock would have to be held by Mesa Offshore as stock in trade or property held by the corporation primarily for sale to customers in the ordinary course of its trade or business, i.e. not as a capital asset. At least one commentator has concluded

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[2] Mesa Petroleum, annual report 1984, p. 27.

[3] The Penn Central Corporation, 1984 annual report, p. 44.

[4] Jonathan Barry Forman, "Using the Tax Code to Fend Off Corporate Takeover 'Sharks,'" Tax Notes 1162, 1164 (March 18, 1985).

[5] The New York Times, June 6, 1984, p. D5.

[6] IRC § 1223(1).

[7] The change to a 6-month holding period for long-term capital gains is effective only for property acquired after June 22, 1984.

that if the hostile bidder is in the business of corporate raiding, the target's stock should not be treated as a capital asset in the hostile bidder's hands under the rule in *Corn Products Refining Co.* v. *Commissioner,* 350 U.S. 46 (1955).

"For example, a developer in the business of buying and selling parcels of land will have ordinary income, not capital income, upon the sale of a parcel of land. The same tax treatment should apply to someone in the business of purchasing and threatening to purchase corporations. *Query.* How many times does an investor have to receive greenmail before it is appropriate to conclude that the investor is in the business of greenmailing?" [8]

In this case, Mesa's acquisition history over the last few years raises a substantial question as to whether it is in the business of corporate raiding and thus whether it holds the stock of its targets as a capital asset or as property for the sale to customers in the ordinary course of its trade or business. [9]

INSTALLMENT SALE

Because Mesa received a five-year note in the principal amount of $796 million in partial payment for the stock of Mesa Offshore, it reported gain on the transaction under the installment method. Mesa's 1984 Annual Report shows almost $145 million as deferred U.S. income tax on gain on installment sale of securities and assets (all or a major portion of which appears to relate to the sale of Mesa Offshore). [10] The Annual Report further states that following the sale of Mesa Offshore, Mesa entered into a new term loan agreement with banks which provided for borrowings of $785 million. Such borrowings were secured by a pledge of the $796 million Penn Central note. In essence, Mesa deferred a substantial portion of its gain on the sale of Mesa Offshore for a period of five years, while immediately receiving the cash equivalent of almost 99 percent of the principal amount of the note. Under some circumstances, the use of an installment note as collateral will be treated as a disposition of the installment note, thus triggering the recognition of any deferred gain. [11] However, the Treasury itself has recognized that "if a taxpayer pledges an installment obligation as collateral for a loan, he may, under some circumstances, continue to defer his tax on the sale." [12] In effect, under the installment method, the federal government makes an interest-free loan to the taxpayer of the tax that otherwise would be due in the year of sale. Treasury recognizes that the benefit of tax deferral is not appropriate where the taxpayer has obtained cash by pledging an installment obligation. To eliminate this abuse, Treasury proposes that on or after January 1, 1986, any amount borrowed that is secured by an installment obligation would be treated as a payment on the installment note.

This legislative change is long overdue. But there are other aspects of Mesa's use of the installment sale that the Internal Revenue Service might well question under existing law. Why did Mesa sell the Mesa Offshore shares to a subsidiary of Penn Central which then sold the Gulf shares when the Gulf shares could have been sold directly to SoCal pursuant to the SoCal tender offer? If Mesa had sold the Gulf shares to SoCal for cash, the gain would have been immediately taxable. By selling the Mesa Offshore stock to the Penn Central subsidiary for consideration which included a note, it was able to defer a significant portion of federal income taxes. This tax avoidance purpose was, in effect, acknowledged by Mesa's Chairman T. Boone Pickens, Jr. who "said in an interview that the deal with Penn Central would allow Mesa to defer some of the income from its Gulf holdings by channeling it into the Penn Central note." [13] Moreover, the transaction was essentially riskless to Mesa

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[8] Forman, supra at note 4.

[9] Since 1981 Mesa and its affiliated companies and associates have been involved in purchases and sales of stock of a number of oil companies, including Cities Service, Superior, GAO, Gulf, Phillips, KN Energy, Supron Energy, and Unocal. Mesa's 1984 Annual Report shows that during the period 1982, 1983 and 1984 the company purchased securities of over $1.4 billion (compared to net oil and gas capital expenditures of less than $660 million). During this same period, Mesa had pretax gain on the sale of securities of over $530 million including a 1984 gain on the sale of securities of over $530 million including a 1984 gain of $404 million on Gulf stock, a 1983 gain of $31.6 million on Superior Oil and $33.2 million on GAO and a 1982 gain of $22.3 million on Supron Energy, $31.5 million on Cities Service and $10.4 million on GAO. In addition, Mesa has a 1985 gain of $80 million on the sale of Phillips stock. Mesa Petroleum, Annual Report 1984, p. 42.

[10] Mesa Petroleum Co., annual report 1984, p. 44.

[11] *See, e.g.,* Rev. Rul. 65-185, 1965-2 C.B. 153.

[12] 2 Treasury, "Tax Reform for Fairness, Simplicity, and Economic Growth," 212 (Nov. 1984).

[13] The Washington Post, June 6, 1984, p. D9.

because Penn Central's payment of the note was secured by bank letters of credit which in turn were backed by Penn Central's pledge of approximately $796 million of cash received from its sale of Gulf stock to SoCal. [14]

It would appear that the sale to the Penn Central subsidiary could be challenged as a sham transaction designed principally for the tax avoidance purpose of permitting Mesa to defer gain under the installment method, rather than being taxed immediately on the full gain if the shares had been sold to SoCal for cash. [15] It could be argued that Penn Central, in effect, acted as the agent for Mesa in selling the Gulf stock to SoCal. If the use of an intermediary to permit the seller to obtain installment sale treatment in a transaction that would not otherwise qualify for such treatment is permissible under present law, a legislative change is in order to preclude that type of abuse.

EXPENSES OF RAIDING

In the course of a hostile takeover bid, significant expenses are incurred including commitment fees in connection with financing the hostile takeover and the fees of lawyers, accountants and other advisors. [16] There is a possibility that such expenses might be claimed as ordinary and necessary business expenses. Since these expenses were incurred in connection with the acquisition of stock, the more appropriate treatment might be to capitalize these expenses as part of the cost of acquiring the Gulf shares. Such expenses thus would reduce the amount of any gain being claimed as long-term capital gain, rather than being treated as an ordinary deduction. This is another area in which a legislative clarification would be appropriate.

CONCLUSION

Mesa's tax treatment of the Gulf transaction has a special importance since Mesa did not pay any federal corporate income tax during the ten-year period 1973 to 1983. Mesa's use of some of the techniques discussed above may have contributed to that result. The tax laws even when properly interpreted provide tax incentives for hostile takeovers that Congress should reconsider, particularly the ability to pledge an installment note in a cash borrowing. Quite apart from legislative change, the Internal Revenue Service has the obligation under existing law to closely examine the tax treatment of the fruits of hostile takeover activity to ensure that there are no raids on the Treasury.

Sincerely,

E. WILLIAM COLE, *Vice President.*

COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC, May 13, 1985.

MESSRS. DOUCE AND HARTLEY. Thank you for appearing as a witness at the Subcommittee's hearing on mergers and acquisitions. Your experience and expertise provided the Subcommittee with much valuable analysis and information. For the purpose of completing the Subcommittee's hearing record, I have enclosed a series of additional questions for your response.

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[14] The Penn Central Corporation, 1984 Annual Report, p. 44. Penn Central's issuance of an installment note backed by a standby letter of credit which in turn was backed by Penn Central's cash deposits raises the question of whether such an arrangement should be treated as a payment subject to immediate tax rather than qualifying for installment sales treatment. IRC § 453(f)(3), amended by the Installment Sales Revision Act, provides that third party guarantees used as security for a deferred payment should not be treated as a payment received on an installment note. Temporary regulations provide that a standby letter of credit even if backed by additional cash collateral is not treated as a payment, but that the deposit of cash in an escrow account which the payee may look to directly in the event of default is treated as a payment. Compare Examples 7 and 8 of Reg. § 15a.453-1(b)(5). A standby letter of credit backed by cash deposits in an indirect escrow arrangement that is the equivalent of a payment. Accordingly, the temporary regulations should be amended to so provide. In the absence of an administrative change, Congress should consider a legislative clarification of this point. Installment sales treatment should not be available in such a situation.

[15] See, e.g., Rev. Rul. 74-87, 1974-1 C.B. 72. See also Ruddick Corp., 83-2 USTC ¶ 9480 (U.S. Cl. Ct. 1983).

[16] For example, pursuant to a December 1984 agreement with Phillips, Mesa will sell back its shares of Phillips stock and be reimbursed for actual expenses up to a maximum of $25 million. Mesa Petroleum Co., Annual Report 1984, p. 42.

I would appreciate your review and response to my office by May 24, 1985. If you have any questions, please contact Bill Cunningham of the Subcommittee staff at 225-5522.

Sincerely yours,

J.J. PICKLE,
Chairman, Subcommittee on Oversight.

Enclosures.

1. Do you feel that the tax laws encourage mergers? If so, which provisions are parimarily used by the parties involved in mergers? Should the tax code be neutral toward mergers? If yes, which provisions of the tax code should be changed and how?

2. Some experts argue that a firm is vulnerable to a takeover when (1) stock is undervalued in relation to its underlying assets; (2) the corporation has a high effective tax rate; or (3) the corporation has substantial liquid assets, including an overfunded pension plan. To what extent have any of these factors been involved in the merger activities of your company?

3. Some experts argue that the tax laws encourage debt financing rather than equity financing since corporations are allowed deductions for interest payments but not for payment of dividends.

(a) Do you agree?

(b) Should the Congress restrict or eliminate the deductibility of interest (1) generally; (2) in all mergers; (3) in "hostile takeovers"; or (4) for "junk bonds"? Please explain.

4. If a line were to be drawn for tax purposes between friendly mergers and hostile mergers, how should hostile be defined? Should a vote by the "independent directors" of the target corporation be determinative? If not, what test or standard should we use? Should the tax code distinguish between hostile and friendly mergers?

5. Have "junk bonds" been utilized in any mergers or attempted takeovers involving your company? If so, to what extent?

6. Have junk bonds been used to raise capital by your company? If so, to what extent?

7. If the deduction for interest payments on junk bonds were denied, do you feel that such denial should apply:

(a) To all junk bonds;

(b) To junk bonds used in connection with any merger or acquisition;

(c) To junk bonds used by any target company to repurchase its own stock?

Please explain your answer.

8. When junk bonds are used by a potential acquiring company, is the security for that financing usually the assets of the target company? If the lenders look to the assets of the target, is there an expectation that certain assets will be sold to service the debt? What would the beneficial and detrimental results of such sales be?

9. How would you define a "junk bond"? Are there other debt or equity instruments with similar characteristics to those of junk bonds that we should be concerned about in evaluating the deductibility of interest?

10. Does the election under Section 338 of the Internal Revenue Code to step up the basis of assets cause mergers to happen or does it instead influence the form of the merger?

11. What impact would a repeal of the Section 338 election have on mergers? Would it decrease the number of mergers and/or affect the terms of some mergers such as pricing?

12. Some experts argue that certain mergers are driven by profitable corporations seeking to offset their income by acquiring firms with net operating losses.

(a) In your experience, has the existence of NOL carryovers been involved in any mergers activity involving your company?

(b) Should consideration be given to limiting or increasing the transferability of NOLs in mergers?

13. There have been recent reports that managements of some target corporations are using Employee Stock Option Plans (ESOP) as a defensive takeover tactic.

(a) Is the use of an ESOP as a defensive takeover tactic consistent with the Congressional intent for such plans?

(b) What problems of employees in such situations should be of concern to us?

(c) Have ESOPs been used or discussed in any of the mergers with which you are familiar? If so, what were the circumstances and what were the results?

14. Has your company made greenmail payments or been asked to make such payments?

15. Should greenmail payments be prohibited or penalized? If so, should such regulation be done through the securities laws and/or the tax laws?

16. Should corporations making greenmail payments be allowed to deduct those payments in whole or in part as ordinary and necessary business expenses? Has your company taken or proposed to take such deductions?

17. Do you feel that oil companies have been focussed on by acquiring companies as attractive takeover targets in recent months? If so, why?

18. What effect has the recent surge in acquisitions and attempted acquisitions had on the oil industry? If you feel that this acquisition activity has had any negative impacts, please explain. Do you feel that all acquisitions are bad? If not, do you feel that all "hostile" acquisitions are bad? If so, why? If not, what is it about the recent merger activity which is of concern to you?

19. What would you consider to be an acceptable debt/equity ratio for your company? Is this typical for the oil industry? At what debt/equity level would you consider your company to be in jeopardy? Hypothetically, do you feel that increasing your company's debt/equity ratio in the course of fighting a takeover attempt is justified? If so, why?

20. Please provide the information requested by Congressman Flippo at the hearing on April 2, 1985, relating to the acquisitions made by your firm in the past. Did you use "junk bonds" in any of those transactions? If so, please explain. Did you increase the debt/equity ratio of any of the acquired companies? Would you have proceeded with any or all of these acquisitions if you had not been able to deduct the interest payments on borrowed funds used to effect the acquisitions? Why or why not?

Responses of William C. Douce

1. We believe that tax considerations should not be the major reason behind mergers. Today, the tax considerations involved in mergers and acquisitions are among many factors generally considered. In any specific instance, tax laws could encourage or discourage mergers, depending upon the facts of a particular merger. However, there are certain situations in which abuses are prevalent.

Phillips has been, and remains, a strong supporter of the free market system. As such, we believe that an economy which operates with minimum government interference is the most productive. Within that free market system, corporate mergers and acquisitions can and do result in appropriate allocations of capital resources. Whether the tax law is neutral with respect to a given transaction depends upon one's role in the transaction. As stated previously, however, there are situations in which abuses exist. Such abuses have recently arisen in the use of highly leveraged junk bonds in hostile corporate takeover attempts. Use of such indebtedness in hostile acquisitions, enables corporate raiders to largely avoid tax at the corporate level, while maintaining little or no equity in the entity acquired. A prime advantage now available to the raider is the ability to deduct interest on the junk bonds used in such proposed hostile takeovers. The current tax laws should be amended in the manner suggested in H.R. 1100 to avoid giving corporate raiders undue advantage in the form of tax benefits.

2. These observations are all generally valid. Some analysts have argued that Phillips stock was undervalued in relation to the value of its underlying assets and that this was the primary reason for our becoming a hostile takeover target. The reasons for Phillips', and more generally the oil industry's, stock being undervalued are explained in more detail in our response to question 17.

(a) The tax code does allow deductions for interest payments but not for payment of dividends. In general, interest is, and should be, viewed as a cost of doing business. Therefore, deductions should continue to be allowed for interest expense, except in the instance of a merger covered by H.R.1100, and it is difficult to differentiate this expense from any other proper business expense. If there is a bias in the tax code, perhaps it is against equity and not "for" debt.

(b) As long as Congress continues to exercise its policy judgment that deductions should not be granted for equity distributions, then it should recognize the substance of hostile acquisition indebtedness and disallow interest with respect to junk bonds issued in hostile acquisitions as specified in S.476 (Boren, D-OK) and H.R.1100 (Jones, D-OK). Interest in other types of transactions should continue to be deductible.

4. A vote by the independent directors of a target corporation (or the absence of an affirmative vote in favor of a corporate raid) should be determinative of whether a merger attempt is hostile. While some have questioned whether it is good tax policy to allow the definition of the term "hostile acquisition" to be dependent upon

the actions of certain members of a board of directors of a corporation, we feel that this is the best alternative. Other methods, such as attempting a definition in the statute, granting the Securities and Exchange Commission the power to make the decision, or granting a court the power to make the decision, are, in our opinion, all less satisfactory.

5. Junk bonds or commitments for junk bonds were utilized in attempted takeovers of Phillips by Mesa Partners and by Carl Icahn. Such bonds, or commitments for such bonds, accounted for much of the financing which would have been used to accomplish the eventual takeover. For example, in Carl Icahn's bid for Phillips, he would have issued $3.9 billion in junior subordinated debt to acquire Phillips stock. This would have left Phillips with $11.3 billion in debt after the takeover, resulting in a 14 to 1 debt-to-equity ratio.

6. Phillips has not used junk bonds to raise capital.

7. If a deduction for interest payments on junk bonds were to be denied, it should be limited to junk bonds used by a raider in connection with any hostile merger or acquisition. See also second paragraph of response to question No. 18.

8. To date, utilization of junk bonds in a hostile acquisition context have usually been financed by the assets of the target company. As Michael D. Brown of Drexel Burnham Lambert Inc. has stated previously: "We take a minnow, identify a whale, then look to its assets to finance the transaction." (Business Week, March 4, 1985, page 90)

There is an expectation that assets will be sold in order to finance the transaction. Business Week recently stated that, "Once in control, the raider can raise cash by selling off pieces of his new property." One result of such sales is the denial of revenues to the government upon the asset dispositions, since the gain on the sales will be largely sheltered from tax by the deductions for interest on junk bonds used to finance the transaction. One analysis of Carl Icahn's proposal for acquiring Phillips showed that the U.S. Treasury would be subsidizing Icahn's raid by as much as $600 million per year. In addition, such asset sales also result in the reduction of research and development, corporate philanthropy, and adverse consequences to employees and communities in which the assets are located.

9. We agree with the junk bond definitions given in both H.R.1100 (Jones, D-OK) and H.R.2476 (Pickle, D-TX). Elements of both of these two bills could be utilized in defining junk bonds. Amending Section 279A(b)(3)(B) of the Internal Revenue Code as contained in H.R.1100 would also appear to be important in any definition for these instruments.

10. Section 338 of the Internal Revenue Code is one of many factors involved in the analysis of a possible acquisition. It may or may not influence the form of the merger, depending upon the transaction. However, it is rarely ignored.

11. The repeal of Section 338 would impact some acquisitions, depending upon the particular circumstances. In some cases it could have an impact on pricing, while in others there would be no impact. If repealed, an important source of flexibility in decision making would be lost and this could have an effect on mergers and acquisition activity.

12. In both 1983 and 1984, Phillips completed two friendly acquisitions of profitable concerns, General American Oil Company and Aminoil. With regard to hostile takeover attempts our experience has been that profitable corporations are the subject of most raids and that the raider, utilizing hostile acquisition indebtedness, effectively eliminates taxation at the corporate level. In our opinion, transferability of NOLs, as such, has not been an important factor in the current surge of attempted hostile acquisitions, and therefore limiting or transferring NOLs would have little or no effect.

13. Phillips proposed an ESOP in connection with the settlement agreement after Mesa Partners' hostile takeover attempt. The ESOP was designed to effect cash cost savings, and to serve as an incentive mechanism in providing employees with a greater stake in the financial results of the operation of the company. The use of the ESOP, which would have accelerated and enhanced the effect of existing plans was subject to the approval of shareholders and was included as part of a major corporate recapitalization plan. We considered this action to be consistent with congressional intent for ESOPs. This recapitalization plan, however, was not approved by the shareholders.

14. Phillips has never made or been requested to make greenmail payments.

15. As a complement to existing law, an excise tax on greenmail payments should be enacted. Securities law regulations such as those contained in S.476 and H.R.1100 should also be considered.

16. Congress should consider the disallowance of deductibility for greenmail payments to the extent they are regarded as stock redemptions. Phillips has not taken

and does not propose to take any deductions for greenmail payments. As stated previously, Phillips has not made any greenmail payments.

17. Yes, oil companies have been focussed on as attractive targets recently. The stock of oil companies historically is substantially below their liquidation or net asset value because of the nature of the business. The petroleum industry is a high-risk, capital-intensive, long-term business. If an exploration project fails to find commercial reserves of oil or gas, sizable economic losses may be sustained. A company must be sufficiently strong to absorb such losses without jeopardizing the shareholders' investments. On the other hand, if exploration succeeds, a discovery probably will require years of heavy cash investment before production begins. For these reasons, the industry must quite often fund new projects from the internal cash flow from current operations. This equity or cash flow funding is necessary to protect the long-term value of the shareholders' investments. Management cannot look solely to short-term gains if it is to meet its responsibilities to shareholders, as well as to the energy needs of our nation. Consequently, the market price does not usually reflect the appraised value of the company. Also, because of recent declining oil prices and the high cost of exploration, it is often more economical to acquire oil reserves rather than try to explore for them. This has been an additional motivator behind hostile takeover attempts in the petroleum industry.

18. The recent surge in attempted acquisitions in the oil industry has accelerated the restructuring that is occurring within the industry. Companies are now looking at ways to raise their market value and thus are looking more at short-term profits than at the expense of long-term investments. As a result of the takeover activity, our long-term plans have been changed to provide more immediate payout to shareholders versus the traditional balance of current return and long-term investment performance. Increased amounts of current cash flow and proceeds from asset sales must be redirected to debt service in lieu of longer-term investment opportunities. This has occurred in our case and will result in Phillips being a smaller company whose long-term objectives must be reduced with respect to replacement of produced reserves and further development of our natural gas liquids, downstream and chemical business lines, as well as long-term research programs.

We do not consider all acquisitions to be bad and we further don't believe that all hostile acquisitions are bad. What concerns us is the fact that the U.S. tax code offers an incentive to the corporate raider by allowing the deduction of indebtedness arising from the use of "junk bonds" in a hostile acquisition. This is why we support legislation which would remove this incentive. Attached for further review is a copy of Phillips' testimony from February 27, 1985 before the House Committee on Energy and Commerce that provides additional information on how we view the potential adverse effects arising from a hostile takeover of Phillips.

19. While it is difficult to state a level at which we would consider the "company to be in jeopardy," we do feel that we need to reduce our debt ratio from its current level of approximately 80 percent. We are striving to reduce our debt/equity ratio to about the 50 percent level. While this level will still be somewhat higher than the industry normal level, the majority of major oil companies have seen their debt/equity ratios climb dramatically in the last five years. In order to accomplish this, we have announced our intentions to sell approximately $2 billion worth of assets in addition to offering an early retirement incentive program to about 2400 of our domestic workforce.

While we would have preferred to leave our debt at a relatively low level, we have no doubt that the increase in our debt/equity ratio during the course of fighting two hostile takeover attempts was justified. By increasing our debt level, we have been able to let our shareholders maintain their investments in a strong and active company while at the same time providing stable employment to thousands of employees and maintaining stability in the communities in which we operate.

20. As stated previously, we have not used "junk bonds" to finance any acquisitions. Our 1983 friendly acquisition of General American Oil Company in a cash merger and the 1984 friendly acquisition of Aminoil in a cash-for-stock acquisition did not increase the debt equity ratio of either company.

If we had not been able to deduct the interest payments for borrowed funds, we feel that the acquisitions would still have been made. However, without the interest deductibility, the price we would have been willing to pay may have been lower than if we were allowed to deduct interest payments.

[Mr. Hartley did not respond to the request.]

PHILLIPS PETROLEUM CO.
Bartlesville, OK, April 3, 1985.

Hon. J. J. PICKLE,
Chairman, Oversight Subcommittee, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: I am writing to commend your decision to hold hearings on the problem of hostile take-over attempts by corporate raiders. There are serious problems that merit attention. The frequency of these raids is accelerating and involves companies from a variety of industries.

We at Phillips Petroleum Company continue to support concepts of the free market. Within the constraints of present law, companies should be able to merge if conditions make it desirable. Shareholders should be free to exercise their rights, including the elimination of poor management.

However, a clear distinction should be made between these activities and those of the corporate raiders who are "in for the quick buck" without regard for anything else. While they represent themselves to be the champions of the shareholder, their actions oftentimes belie their claims. It is apparent that their own enrichment is the driving force and that the interests of the long-term shareholders, employees, communities, and the society that the companies serve are of little concern.

Having been through the experience of seeing our company attacked by two raiders within about two months, we can confirm that it is a bad, counterproductive experience. If the raiders are permitted to continue at the accelerating pace we are witnessing, it can undermine the health of much of corporate America. This is particularly true for industries that depend on long-range planning, research, and investments that may not contribute to earnings for several years.

We hope that appropriate action can be taken to correct this menacing problem while preserving a healthy free market.

Very truly yours,

WM. C. DOUCE.

Chairman PICKLE. Now the Chair would like to have Mr. Robert Profusek, and Mr. Eugene Keilin.

Please come forward to the witness table.

I don't care which order you take your seat. We will start with Mr. Gleacher over here on the right; then Mr. Perlmutter next to Mr. Gleacher; then Mr. Profusek next to Mr. Perlmutter; and then Mr. Keilin.

I will ask Mr. Gleacher, who is managing director of the Morgan Stanley & Co., if he will present his testimony first.

STATEMENT OF ERIC J. GLEACHER, MANAGING DIRECTOR, MORGAN STANLEY & CO., INC.

Mr. GLEACHER. Thank you very much, Mr. Pickle. It is a privilege to be here.

I have submitted written testimony which I would ask to be inserted into the record.

Chairman PICKLE. Without objection, the entire statement will be made a part of the record.

Would you care to summarize your general feelings or your statement?

Mr. GLEACHER. Yes; I will summarize them. I would like to begin with a few comments about my background, so you can see what my biases are. I will tell you a little bit about how our business works and offer our view of the issues that you have been discussing today.

I have been in the investment banking business for almost 18 years. I have been spending 100 percent of my time in the merger and acquisition part of the business since 1977. I have represented

clients, in approximately 100 transactions—bidders, buyers, sellers—all over the world.

I am responsible for Morgan Stanley's merger and acquisition efforts, which is a very large business. In 1984, we represented companies in 79 transactions with a total dollar value of $52 billion, which ranks us right up at the top of that business for the past year.

I think it would be interesting for the committee to note that in none of those transactions, in our opinion, was tax the motivating force. In other words, none of those deals were driven by tax angles, motives incentives or advantages.

There have been three specific examples of potential tax motivation for mergers mentioned today. One is the deductibility of interest on debt. The second is the step up of assets. The last is NOL's, net operating loss carryforwards.

I can tell you from my experience and our experience as a firm that none of those factors propel the mergers and acquisitions we work on. By and large, what we do is represent major companies all over the world in redeploying their capital and making strategic investments of their capital for a variety of reasons. I will explain a couple of those in a minute.

Chairman PICKLE. You said none of them are tax motivated. Were any of your companies that you mentioned comprising this total amount involved in some of the prominent takeovers that we have been discussing?

Mr. GLEACHER. Yes; we recently represented Phillips in the Mesa Petroleum deal that has been discussed here. We represented Chevron in the purchase of Gulf. We represented Superior Oil which sold out to Mobil. Those are three of the major oil transactions that were mentioned today, however, there is a variety of other companies involved in the 79 deals we have worked on.

Many of them were very large deals. The average size is obviously close to $1 billion, but the vast majority of them are in the $400 to $500 million range.

I would like to make a point about mergers and acquisitions and the deductibility of interest. Every year there are a few thousand mergers and sales of companies conducted here in the United States. Most of these are small businesses or family businesses that are sold because people get to the point where they are going to retire or some event occurs where the sale becomes advisable. In most of those transactions, borrowed money finances the purchase.

When Congress considers the issue of deductibility of interest on merger transactions, my suggestion is that you keep that in mind; the vast majority of mergers involve interest-bearing debt to enable the shareholders of the company can cash out and someone else to take over the businesses.

Mr. FLIPPO. Would the Chair permit a question at this point?

Chairman PICKLE. Yes.

Mr. FLIPPO. If the deductibility of interest has no role to play in mergers and acquisitions, then I assume that you wouldn't have any objections if we changed the law in regard to deductibility of interest in regard to it. I assume from your statement, then, that mergers and acquisitions would go forward as they have anyway. Is that right?

Mr. GLEACHER. Yes, that is right. At least many of the mergers and acquisitions would still occur.

I think I agree with what Mr. Douce said. When he was asked what would happen if the deductibility of interest were removed, he replied that he thought that the transactions would occur but at prices lower to shareholders.

Mr. FLIPPO. If we adopted the suggestions of Mr. Jones that we somehow figure out how to define it and deny the interest deduction in regard to mergers and acquisitions, you wouldn't object to that?

Mr. GLEACHER. I wouldn't support it. Whether it is a question of objecting or supporting, I wouldn't support it because I believe that the system as it stands now is best because it maximizes the value that the shareholders receive. That is why I think shareholders invest in companies.

But if the question is, would that stop merger and acquisition activity, I would say, no, it wouldn't. It would just reduce the proceeds to the shareholders.

Mr. MCGRATH. Would the gentleman yield?

Mr. FLIPPO. I'll be delighted to.

Mr. MCGRATH. I think what Mr. Gleacher has already said, and perhaps just intimated, is that, without the ability to borrow and deduct, perhaps companies within the same family couldn't be transferred from father to son or mother to daughter. Am I correct?

Mr. GLEACHER. That is correct.

Mr. FLIPPO. Yes; I am not necessarily advocating what Mr. Jones is advocating. I am trying to get the testimony of the witness that tax has no role to play in the mergers and acquisitions.

Mr. GLEACHER. Let me try to restate it again, Mr. Flippo. The tax aspect is not a motivating force with companies making acquisitions. However, no acquisitions should be completed without at least considering the tax impact of its structure, such as whether the payment is in the form of cash or securities, the amount of the payment and in the way the deal is structured. Careful consideration is obviously given to the tax aspects of every single transaction that we are involved in.

However, the key point is that the companies retaining us around the world are not seeking out opportunities where there is a special tax angle from which they can benefit. They first look at what they are doing, what kind of company they want to acquire and why, and then they maximize the benefits to themselves.

Mr. FLIPPO. Are you saying the first man he calls is the banker, but the second man he calls is the tax man? Is that right?

Mr. GLEACHER. Well, the tax man or the banker may be one and the same in the case of investment bankers' services.

Let me clarify this by describing our organization. As I indicated, our organization does a lot of business in this area. We have 80 professionals who work in our mergers and acquisitions department, and only one is a tax expert. I think you might agree that, if the tax aspects of what we do are critical, there would be more than one-eightieth of our personnel involved in that area.

Mr. FLIPPO. Yes. I think I understand.

In these mergers where you get a stepped up basis for even items including inventory, if the committee saw fit to deal with some of those, it really would not have any impact on these mergers?

Mr. GLEACHER. It may surprise you to know that it probably wouldn't have much of an impact.

Mr. FLIPPO. Good. Thank you.

Mr. GLEACHER. I don't know exactly how many of the transactions we did this year in which there was a step up, but it was a very small number.

As I said, our view is that while taxes are a factor which is considered, but they are not the motivating or driving force in this process.

The SEC recently filed a brief in a lawsuit involving the famous poison pill securities. I would like to just read you one or two sentences of that because I think it articulates well the kind of attitude we have to the marketplace.

It says:

> The consistent view of Congress and of the SEC has been that the decision whether to accept or reject tender offers should be left, after full disclosure by management and bidders, to the shareholders.

We believe and I believe that under this system our capital markets have done very well over the past 50 years. They are extremely liquid. The size of the public debt and equity markets in this country exceeds the size of all the other capital markets in the world combined. The system is a free market system and has done well in that form.

From our viewpoint, as I said, we do not see tax angles that are being employed and manipulated by companies. The markets work well and the shareholders have been well served over a period of time.

[The prepared statement follows:]

STATEMENT OF ERIC J. GLEACHER, MANAGING DIRECTOR, MORGAN STANLEY & CO. INC.

I. INTRODUCTION

My name is Eric Gleacher. I am a Managing Director of Morgan Stanley & Co. Incorporated, a major investment banking concern, where I am Director of the Mergers and Acquisitions Department. Prior to my arrival at Morgan Stanley in 1983, I was with another investment banking firm, Lehman Brothers Kuhn Loeb, Incorporated, for over 15 years, and founded its mergers and acquisitions department in 1977. During the past ten years, I have acted as the financial advisor to bidders, targets and third parties in over 100 tender offers and merger transactions. In 1984, my department was involved in 79 acquisition transactions for an aggregate value of $52 billion. None of these transactions were tax motivated.

I welcome the opportunity to appear before you to discuss some of the public policy implications of tender offers, mergers and acquisitions. I am speaking as an investment banker and not as a tax expert. In fact, in our mergers and acquisitions department, we have almost 80 professionals, of which only one is a tax professional. This fact is very revealing; if mergers and acquisitions were truly tax driven as some have asserted, I can assure you that we would have a full complement of tax experts fully assimilated within our mergers and acquisitions department.

A. Context of hearing

At the outset, I would like to place this hearing in context. At least eight (8) committees of Congress are currently considering legislative action in response to allegations of abuses and perceived gaps in regulating tender offers, mergers and acquisitions. Our position before each of these committees is uniform; we desire to preserve the overall balance and neutrality of our laws between bidders, targets and

investors. Before you or the other committees take any action, you should consider three threshold questions.

First, is there a problem in the tender offer, mergers and acquisitions area requiring legislative action? Most of the compelling evidence with which we are familiar argues forcefully that tender offers and mergers are good for shareholders and beneficial for the economy.

Second, is there a regulatory gap? Over the last half-century, Congress has created a complex and delicate system of federal regulation that, together with state regulation, has generally been effective in weeding out abuses while maintaining strict neutrality between the various economic interests involved in takeover transactions. These laws permit the market instead of government decisionmakers to determine the most efficient way to allocate resources. Changes directly, or even indirectly through the tax laws, threaten this neutrality between bidders and targets and jeopardize the health of our capital markets.

Finally, if there is a desire to restrict the number and size of takeovers or the intensity with which certain takeovers are conducted, are changes in the tax code the most effective and least intrusive way to achieve this objective?

B. Summary

Each of these questions should be answered in the negative. In short, we do not believe that the Committee should propose tax legislation specially targeted against tender offers, mergers and acquisitions for several reasons.

1. Acquisitive transactions result from specific economic opportunities arising from independent business and market considerations.

2. Although the tax law may be a consideration in a transaction, it is not the reason or even a driving force for the mergers now occurring. When the prices offered to shareholders in an acquisition often approach twice the market price and no basis adjustment is made to the assets, no reasonable person can say the deal was tax driven.

3. While we believe no changes are necessary in the current regulatory structure for acquisitive transactions, if Congress determines that changes are necessary, the proper forum, if any, is to amend the securities laws.

4. If the tax law is amended, acquisitions will continue to occur as long as the gross premiums which could have been offered to shareholders under old law exceed the new taxes which arise from the transaction. It is important to realize shareholders will suffer a reduction in the premium that can be offered for their stock to the extent new taxes are imposed on the acquiring and/or target corporations.

II. CURRENT REGULATION OF MERGERS AND TENDER OFFERS

In attempting to answer the three threshold questions, it is useful to put the tender offer process in the perspective of our nation's capital markets. The great weight of the evidence expressed during debate on anti-merger legislation in the Senate last year, as well as that presented earlier this year before the House Energy and Commerce Committee's Subcommittee on Telecommunications, Consumer Protection and Finance, generally recognized that tender offers represent an efficient method for the allocation of managerial and capital resources within a free market economy and provide a mechanism for shareholders to realize value on their investment.

The basis of our system of market regulation is to provide investors adequate information through disclosure of the relevant facts and sufficient time to make an informed investment decision. As the Securities and Exchange Commission recently stated in its amicus brief in *Moran* v. *Household International, Inc.*, the poison pill case currently before the Delaware Supreme Court, "[T]he consistent view of Congress and of the Commission has been that the decision whether to accept or reject tender offers should be left, after full disclosure by management and bidders, to the shareholders." Under this system, our capital markets have grown over the last 50 years to become the best in the world with a depth and liquidity second to none. In fact, the size of the U.S. public debt and equity markets approaches $7 trillion, larger than the combined value of all remaining markets in the world. The size and liquidity of our capital markets is a critical element in the ability of corporate America to raise amounts of capital in a highly efficient manner.

Fundamental to the functioning of our securities markets is the pricing mechanism provided by the free access of buyers and sellers, each of whom has a view of values that is translated by the market into securities prices. Implicit in this approach to market regulation is an obligation on the part of the shareholder to follow developments which affect the value of his investment.

Notwithstanding the recent barrage of press attention devoted to certain takeover tactics, concern over takeovers is not new. The Williams Act, which governs the procedures involved in takeovers of publicly-held corporations, was passed in 1968 to regulate tender offers. It is based on a Congressional determination that tender offers should be regulated primarily for the protection of investors to ensure full and fair disclosure, protect shareholders from fraud and manipulation, and provide for procedural fairness in the takeover process. The objective has been to let the market rather than regulation dictate the price and form of the acquisition transaction.

Congress was convinced that takeover bids should not be discouraged because they serve a useful purpose in providing a check on entrenched but inefficient management. Drafters of the Williams Act sought neither to encourage nor discourage takeover activity. The Senate Committee Report noted:

"The committee has taken extreme care to avoid tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid. The bill is designed to require full and fair disclosure for the benefit of investors while at the same time providing the offeror and management equal opportunity to fairly present their case." S. Rep. No. 550, 90th Cong., 1st Sess. (1967).

As the Office of Management and Budget has pointed out, the parties in interest would welcome efforts to tilt these rules in their favor. [1] Not surprisingly, the partisans are currently conducting active campaigns to encourage such efforts. Moreover, viewed separately, each side can make a seemingly appealing argument that it deserves concessions because the other side currently possesses a legislative advantage. While there may be discrete areas, such as greenmail, where action might be warranted, these emotional appeals to alter the securities, antitrust or tax laws should not be allowed to cause the distortion of an overall system of regulating tender offers that has worked well.

III. VALUE OF CORPORATE ACQUISITIONS

A. Corporate acquisitions benefit society

In determining whether to propose legislation, you should consider the substantial evidence that takeover contests are, in the aggregate, beneficial for shareholders and for the economy as a whole. On March 12, 1985, Joseph R. Wright, Jr., Deputy Director of the Office of Management and Budget testified on behalf of the Administration that takeovers can perform several valuable functions, such as:

1. To allocate resources to higher valued uses;
2. To promote economies of scale and scope;
3. To increase investors' return from the stock of publicly traded companies, and thereby increasing the incentives to invest therein;
4. To reinforce market incentives that require management to compete effectively;
5. To free up capital for new investment opportunities; and
6. To move assets to smaller, more focused companies. Wright concluded that takeovers often take place because a company's management has, over a long period, failed to deliver to stockholders the full value of assets owned by that company. "Sheltering publicly traded corporations from the discipline of the marketplace," he stated, "threatens the integrity of the marketplace." [2]

The Council of Economic Advisers' 1985 Economic Report to the President ("Economic Report") contained an extensive discussion of "The Market for Corporate Control". It concluded that "the current state of knowledge strongly indicates that further regulation of the takeover process . . . would be poor economic policy." It focused on three general areas in which takeovers generate aggregate net benefits to the economy: (1) Production and distributional economies, including economies of scale and technology transfers; (2) shifting of assets to higher valued uses; and (3) improved management.

B. The evidence supports the benefits of takeovers

1. Shareholders benefit

Extensive research has established that the benefits of takeovers to the economy as a whole exceed their costs. Successful takeovers substantially increase the wealth of stockholders in target companies. Although the magnitude of wealth increases vary, recent studies found premiums over the unaffected market price averaging

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[1] OMB Letter to Hon. Timothy E. Wirth, dated October 22, 1984.

[2] Statement of Joseph R. Wright, Jr., Deputy Director, Office of Management and Budget, before the Subcommittee on Telecommunications, Consumer Protection and Finance, of the Committee on Energy and Commerce. March 12, 1985.

30% from tender offers, 20% from mergers and 8% from proxy contests. [3] In fact, the SEC's Chief Economist, in a study of tender offers between 1981 and 1983, found that shareholders received premiums over market value of, on average 31.3% for partial offers, 55.1% for two-tiered offers, and 63.4% for any and all offers. 49 Fed. Reg. 26755, 26760 Table 4 (June 29, 1984).

The data indicates that the shareholders of the bidding companies also experience an increase in the value of their shares as a result of takeovers. This amount of the average price gain ranges from the 2.3% cited in The Economic Report to the 4% discussed by Jensen. Although this gain appears small, it masks a significantly larger return on the assets acquired by the purchasing firm. Since, on average, the purchasing firm is much larger than the firm it purchases, the Economic Report interprets this 2.3% price gain as equivalent to a 9 to 11% average return on the assets of target firms to bidding stockholders. Even corporations which successfully resist a tender offer often benefit from the experience. Martin Marietta's Chairman, Thomas Pownall, recently acknowledged that its takeover battles have resulted in its becoming stronger, faster growing and more profitable than it ever was. The Bendix situation forced Martin Marietta's management to restructure its assets and operations more quickly than it would have. The market price of its stock has tripled as a result. [4]

2. Credit markets do not suffer

One hypothetical concern about mergers and acquisitions is that they crowd out more productive applications of bank financing. This concern is unfounded. Purchase prices in corporate takeovers represent the transfer of wealth from the stockholders of bidding companies to the stockholders of target companies, rather than the consumption of welath. Funds borrowed to purchase shares are either reinvested, consumed or used to repay debts by the selling shareholders. To the extent the funds are reinvested, they replenish the capital available. To the extent the proceeds are consumed or used to repay debt, they are recycled into the credit stream in the same manner as other income. To the extent the proceeds are used to pay taxes arising from the transaction, such as the estimated $2 billion in capital gains taxes arising from Socal's acquisition of Gulf, the government may avoid additional deficit financing.

C. Long term planning

Some critics complain that takeovers reduce long-term investment planning by corporations due to the market's concern with short-term earnings. This argument is supported by no credible evidence and is logically inconsistent. If a company continually avoids long-term investment, it will eventually lose its ability to compete.

I do not believe that sound managers must behave myopically, by sacrificing long-term benefits to increase short-term profits, solely due to the fear of a takeover. The equity markets value growth potential as well as current earnings. This is evidenced by the widely varying price/earnings ratios at which different stocks sell. For example, the market has long valued growth stocks at a premium, notwithstanding their low short-term cash flow and earnings. This scheme has continued in recent years as new issues of start-up companies with little or no record of current earnings are sold at substantial prices and price/earnings ratios approaching infinity.

Quite simply, only bad management will focus almost exclusively on short-term plans. Managements that allocate capital to higher valued uses, operate efficiently and adopt capitalization structures responsive to prevailing financial markets are far less likely to be subject to takeovers than other groups.

IV. CONSIDERATIONS IN STRUCTURING AN ACQUISITION

A. Mergers are capital transactions based on economic considerations

Most mergers are driven by the desire to acquire undervalued assets, to achieve economies of scale, to remove entrenched and inefficient management or to enter new product areas or markets. The present growth in acquisition activity is also due to the improving economy and interest rates and continuing opportunities to enhance shareholder value. These are economic considerations.

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[3] Jensen, "Takeovers: folklore and science," Harvard Business Review Nov.-Dec. 1984, P. 109 ("Jensen"); Jensen and Ruback, "The Market for Corporate Control—The Scientific Evidence, 11 Journal of Financial Economics 5 (1983). The Economic Report cited studies indicating gains of 16 to 34 percent. These gains are exclusive of market price trends.

[4] See "Thank You, Bill Agee," Forbes, March 11, 1985, page 44.

Mergers are essentially capital transactions involving the change of ownership or the redeployment of assets in a manner dictated by market forces in which the acquiring corporation believes it can realize greater value for the shareholders than present, whether the acquisition is friendly or hostile. For example, when Nabisco and Standard Brands consolidated their operations into a new corporation, Nabisco Brands Inc., it provided both companies with greater marketing clout. Nabisco was able to utilize Standard Brands greater international presence, while Standard Brands took advantage of Nabisco's domestic presence.

Once a determination has been made to attempt to acquire another business, it can be accomplished in a variety of ways, and the tax consequences of each structure may differ significantly. Obviously, the tax considerations play a role in which structure is selected, but these considerations are subsidiary to the business objectives and financial statement impact of the acquisition.

We are often faced with situations in which one entity, the bidder, determines that the economic considerations warranting a bid for a target corporation are present. It approaches the target's management and/or makes a tender offer for its stock. For whatever reason, the target's management may reject the bid and seek another suitor, commonly referred to as a "white knight" by whom it would rather be acquired. The management of the "white knight" does not act as a favor to the target or its management. It will not proceed unless it determines that the acquisition is in its best interests, i.e., the same economic considerations must be present, including a belief that the target's operations which it expects to retain will blend well with its own operations and its long-term plans.

B. Tender offer or negotiations

When the bidder and target are able to negotiate the terms of a merger or acquisition in private, we have the maximum flexibility in structuring a transaction. Accordingly, tax considerations such as the use of tax-free reorganizations are more likely to come into play in those situations. However, even then, we are generally more concerned with the financial statement impact of the transaction.

One example of these economic considerations is the acquisition of ABC by Capital Cities Communications announced two weeks ago. According to the Wall Street Journal, the Chairmen of the two companies considered but quickly discarded the sale of Capital Cities to ABC. Since Capital Cities executives would be in charge of the new company, they believed its shares would trade closer to the price/earnings multiple of Capital Cities. Because ABC was trading at a lower price/earnings multiple and had a larger number of shares outstanding, each additional dollar of earnings would translate into a larger increase in the per share price of Capital Cities than of ABC. [5]

The financial markets have reacted favorably to the transaction, with Capital Cities' stock rising in price as well as ABC. In fact, the transaction caused the market to favorably reevaluate the value of most companies engaged in broadcasting.

If it is determined that negotiations are or would be unsuccessful, an offer to purchase shares is generally made to the shareholders. The pricing of such an offer is based on a large number of variables, depending in large part on how the bidder intends to deploy the assets of the target.

C. Tax considerations

In the past, certain transactions were perceived by some as tax motivated. Perhaps the best example is U.S. Steel's acquisition of Marathon. U.S. Steel acquired Marathon in order to reduce its dependence on a mature, declining product line. I believe the transaction was based on and motivated by sound business considerations. After U.S. Steel acquired the stock, Marathon distributed some of its assets to U.S. Steel in a partial liquidation, thereby increasing its basis for depreciation and depletion, but deferred the recognition of recapture income under the consolidated return regulations.

Whether or not the Marathon acquisition should be regarded as a tax motivated transaction, that scheme was eliminated by TEFRA in 1982. Yet, bids and acquisitions continue for oil and gas companies. The 1984 tax reform act restricted certain other tax benefits which were available. Despite the virtual elimination of tax opportunities and incentives through the passage of the 1982 and 1984 tax reform acts, merger activity and the restructuring of the oil industry is continuing. Moreover, in

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[5] See "ABC Won't Yield Its Name in Merger With Smaller Firm", Wall Street Journal, March 22, 1985, P. 7. This price impact will probably be a short-term phenomenon. Over the long-term, I believe the market would adjust its price/earnings ratio regardless which company survived.

most large acquisitions involving stock purchases, the acquiring company does not elect the potential tax benefit of treating the transaction as an asset acquisition. This demonstrates further that this merger activity is not tax motivated; as long as some investors perceive assets to be undervalued and to provide significant opportunities to enhance their value for their own shareholders, these mergers will occur.

Last year, the Senate Finance Committee held extensive hearings to determine the impact of Federal income tax laws on oil and gas company mergers and acquisitions. (Then Deputy) Assistant Secretary (Tax Policy) Ronald Pearlman concluded that—

"[T]he current tax rules would not appear to be propelling the recent flurry of oil corporation acquisitions. We do not believe that Congress should amend the tax laws for the purpose of discouraging these mergers."

A close reading of the Finance Committee's report indicated that it was not endorsing wholesale changes.

V. TAX POLICY AND LEGISLATIVE PROPOSALS

A. The tax system must remain neutral to the private market

The Treasury Department's Report to the President on Tax Reform issued last November stated that its primary goal was economic neutrality. It recognized that:

"One of the primary advantages of a free market economy is its tendency to allocate economic resources to their most productive uses. An ideal tax system would interfere with private decisions as little as possible. That is, it would not unnecessarily distort choices about how income is earned and how it is spent. It would not needlessly cause business firms to modify their decisions on how to finance their activities. A neutral tax policy would not induce businesses to acquire other firms or to be acquired by them merely for tax considerations. It would not discourage risk-taking or the formation of new businesses. In short, an ideal tax system would be as neutral as possible towards private decisions. Any deviation from this principle represents implicit endorsement of governmental intervention in the economy—an insidious form of industrial policy based on the belief that those responsible for tax policy can judge better than the marketplace what consumers want, how goods and services should be produced, and how business should be organized and financed." *(Deletions omitted.)*

I am reserving judgment on Treasury's specific proposals. However, I think its goal of economic neutrality is important in the context of mergers and acquisitions. Any legislation which you consider in the context of mergers and acquisitions must be measured against this standard.

I certainly am not going to claim that our current system of taxation is perfect. However, at present, tax policy neither enhances nor inhibits acquisitions; instead it has allowed the market rather than government to control the decision-making process. Our goal is similar to Treasury's goal—a level playing field in which the tax consequences should not influence, but instead will follow, the business considerations.

B. Tax law is inappropriate medium

The tax law is an inappropriate medium for dealing with acquisition policies for several reasons. If changes are needed in the balance drawn for acquisitions, a point which I would dispute, they should be enacted directly under the securities laws rather than indirectly through changes in the tax law. This will avoid disrupting the delicate regulatory balance under the securities laws, inconsistencies in the tax law and unintended consequences.

1. Avoid inconsistencies in tax law

Many of the legislative proposals to amend the tax laws in the acquisitions context are simply reactive legislation designed to protect constituents rather than based on sound tax policy. For example, one proposal is to deny the deductibility of interest on debt incurred to acquire another company. Contrary to the claims of its proponents, the interest deduction is not a "tax subsidy" favoring mergers.

Our tax laws have always permitted the deductibility of interest for funds borrowed for business or investment, whether used to purchase stock or real assets, or for general operating purposes. No distinction is drawn on the deductibility of interest between funds borrowed from banks and other institutional lenders, debentures issued on the market or seller financing, so long as it represents bona fide debt. There is no reason to view the acquisition of another company through merger as any different than we would the acquisition of other assets used in its business. The resultant entity's income would not be properly measured if the interest deduction were denied.

There is no basis to discriminate against mergers as opposed to other types of capital transactions. Denying the interest deduction would also prevent the most efficient allocation of capital in our economy. Income tax law should not attempt to dictate credit allocation in the free market, thereby causing the removal of the highest bidders in a targeted industry from the market. This is bad tax policy and bad economic policy.

If you attempt to limit interest deductions only on acquisition debt, problems will arise in defining such interest. Money is fungible and any definition will be both overinclusive and underinclusive; attempts to distinguish between funds generated by cash flow from operations, general indebtedness and acquisition indebtedness will inevitably fail.

Finally, acquisitions will be restructured. If the interest deduction is limited, more stock for stock transactions would probably occur.

2. Avoid meaningless distinctions

Some of the legislative proposals condition the tax consequences of an acquisition on whether the target company consents to the acquisition. If the acquisition is consummated, there is no economic difference between a friendly or hostile acquisition. In fact, most consummated acquisitions which began as hostile deals ultimately take place with the approval of the board of the acquired corporation. If any adverse impact on an acquired company arises from a transaction, it will occur whether or not the acquired corporation's board ultimately approves the acquisition. Conditioning the tax consequences of the acquisition on whether the target's board ultimately approves it serves no useful purpose, and could prevent some tender offers from occurring; it may not be worth the risk to consummate an acquisition if you do not know how the transaction will be taxed. Alternatively, the bidder will offer a smaller premium, a result harmful to shareholders.

Conditioning the tax consequences of an acquisition on the blessing of the board of the acquired corporation would be bad tax policy. It is contrary to Treasury's desires to have the tax code be neutral and to subject taxpayers with exactly the same income and expenses to the same tax. Their tax should not hinge on the decision of a third party.

Moreover, such a proposal may have unintended consequences. If a hostile/friendly distinction were adopted in the tax code and based on a vote by independent directors at any time prior to a change in control, it could provide an advantage to hostile bidders. The hostile bidder could offer $X per share if the target's board approves, and $X-Y per share if it does not. This puts additional pressure on the target's board to consent to an uninvited bid. A second unintended consequence could arise when a friendly acquisition is approved by the board. A rival bid for a higher price may be discouraged if the bidder does not believe it can obtain the target board's approval because the additional taxes would absorb the premium otherwise available to be offered to shareholders.

In passing such legislation, Congress would not be saying that all acquisitions are bad; Congress would not be saying that all acquisitions which started as hostile tender offers are bad; Congress would not even be saying that all tender offers which disrupted a corporation or a community are bad. Instead, Congress would merely be saying that an acquisition on terms acceptable to the shareholders of a corporation, although not to certain members of its board, are bad. Yet, if a majority of the shareholders are willing to vote by tendering their shares, should the board of directors which was supposed to have represented those shareholders be able, as its last act, to take revenge on the acquiring entity? That is neither sound tax nor economic policy.

3. Need for a cohesive tax policy

General tax reform proposals are currently being considered by Congress and the Administration. Moreover, the Senate Finance Committee is currently preparing a new draft of its proposals to revamp the corporate tax. These tax proposals are following three major tax acts in the last four years. All of this activity is creating uncertainty and discontinuities in the market.

We would prefer to see no tax legislation affecting mergers and acquisitions. If such legislation is seriously considered, we would hope to see such consideration in the context of an overall review of Subchapter C or the Internal Revenue Code in general, whic his designed to be neutral on business decisions. Moreover, we hope that no tax legislation is enacted which would disturb the delicate balance currently drawn between bidders, targets and shareholders under the securities laws.

4. Unintended consequences

In 1984, Congress amended the tax laws by disallowing deductions by the employer for golden parachute payments and imposing a 20% excise tax on their receipt by individuals. This was in response to very large payments under employment contracts to certain executives in hostile takeovers. According to the Blue Book, Congress was concerned that golden parachute contracts were sometimes adopted as part of a takeover defense to discourage potential buyers from becoming interested.

This foray of the tax law into a non-tax area has caused more problems than it has solved. First, the golden parachute provision is overbroad and covers employment contracts which should not be considered golden parachutes. See "Tax Bill, Aiming at Parachute, Wallops Variety of Pay Packages," Legal Times, July 16, 1984, p. 1. Second, it has created a new anti-takeover device. A company which offers golden parachute contracts to every officer will be a less attractive target because the payments under such contracts will be nondeductible. By acting indirectly through the tax laws, Congress has not only disrupted routine corporate planning, but has encouraged the very activity it sought to restrict.

C. Conclusion

Tax policy should not be divorced from other Congressional action. Congress has repeatedly attempted to maintain a delicate balance between bidders and targets in tender offers. The currently proposed tax legislation would alter this balance in favor of the management of targets, although not necessarily in favor of their shareholders. Although many anti-takeover devices may be designed to insure that all shareholders receive fair and full value for their share, the proposed tax legislation would cause shareholders to receive less. What purpose does this result serve? If the purpose of the proposed tax legislation is to alter the balance between bidders and targets, with all due respect to this Committee, this is a securities and not a tax issue. If its purpose is instead to raise revenue, this result is unlikely; certain transactions may be deterred, with no net revenue gain.

VI. GREENMAIL

While there may be some merit to prohibiting or restricting greenmail payments, we strongly oppose the so-called "greenmail" provisions in some of the tax bills which have been introduced. I believe that if Congress determines that greenmail should be restricted or prohibited, the better way to achieve this result is to amend the securities law directly rather than through the indirect means afforded by the tax code. In golden parachutes, we have seen the unintended impact of indirect securities regulation by amending the tax code.

If greenmail payments are to be restricted by tax legislation, it should merely prevent greenmail and not be designed to stop all takeovers and tender offers, and thereby limit investment in stock. Greenmail is properly defined as the purchase by a corporation of its securities from a large, relatively new shareholder where either the same offer to repurchase is not made to all shareholders or the offer is approved by a majority of the shareholders. See, e.g., H. Rep. 98–1028, 98th Cong., 2d Sess. 30. Any broader definition of greenmail is incorrect and would have the effect of deterring investment and disrupting our capital markets.

VII. CONCLUSION

In conclusion, taxes are not the driving force behind the mergers and acquisitions occurring today. These mergers are driven by economic forces and their structure largely turns on operational and financial statement considerations. If your concern is to regulate practices in mergers and tender offers, the tax law is not the proper area of your focus.

Chairman PICKLE. The next gentleman. I want to be sure I have you in order. Are you Mr. Perlmutter?

STATEMENT OF LOUIS PERLMUTTER, PARTNER, LAZARD FRERES & CO.

Mr. PERLMUTTER. Yes, sir.

Thank you, Mr. Chairman, members of the committee.

It is a privilege to be here because obviously we are discussing important matters, matters in which, as evidenced by the testimo-

ny today, reasonable men differ in terms of the economic efficiency of the takeover process.

I am an investment banker, a partner in Lazard Freres & Co., whose business is providing financial advice to large corporations. In the course of this work I have represented companies on both sides of the takeover process.

It has been a long day, the hour is late I know, and I won't test the indulgence of this committee. I will confine my remarks to the tax impact on the acquisition decisionmaking process, but I will submit a written statement for the record, with your permission.

Chairman PICKLE. Yes, it will be included.

Mr. PERLMUTTER. It expands further on some of the issues that we discussed today.

I think it is important to distinguish between various types of takeover activities because the motives change, depending on the nature of the activity.

In the public company area, the basic decisions, as my colleague Mr. Gleacher has indicated, are strategic. Managements are faced with slow growth, intense competition, changing markets, changing technology, and one of the rational responses to meet those conditions and challenges is an acquisition.

Taxes do not play an impact on the basic strategic thrust which, in our opinion, drives the many thousands of transactions that take place in the course of any given year.

Even in terms of the structuring of the transactions—how much is cash, how much is stock, what combination of each—the analysis is a financial analysis, a financial reporting analysis. What impact will this transaction have on earnings per share? What will it have on the balance sheet? What will it do to the credit ratings? That, more than taxes, determines the mix of the consideration to be offered to the target company.

It is only when those issues are satisfactorily resolved that we get to tax considerations. Obviously if the strategic decision is to proceed and it can be done in a financially reasonable manner, it is important to structure the transaction in the most tax-efficient way.

From the acquirer's point of view, the most important issue is whether he is going to write up assets or not. Again, as Mr. Gleacher stated—and I will just confirm—in almost all of the major transactions that I have been involved, the decision was not to write up assets because the recapture incurred in writing up the assets more than offset the advantages of having higher writeoffs into the future. The selling corporation's historic basis in assets were retained. Thus, on the most critical issue, acquirors, for the most part, are not utilizing the opportunities to write assets up.

When we turn our attention to another type of takeover activity—let's call it the financial entrepreneur acquiring shares in the marketplace—the motivation is almost exclusively, as we have heard from testimony today, whether the shares are undervalued or not.

If undervalued, the entrepreneur is prepared via various programs, whether liquidation, a proxy fight or a spinoff or an upstream merger, to try to realize greater values for the shares. If he is right about that, all the shareholders benefit. If he is wrong, he

suffers the consequences of making a bad investment decision. The market will determine this, and it is a strict and demanding judge.

Just a comment, if I may, on some of the proposals that try to distinguish between hostile and friendly transactions and proposing to eliminate deduction on acquisition interest incurred in hostile transactions.

It is a very difficult judgment call to determine if these hostile transactions are any better for the economy in the aggregate than friendly transactions. Setting legislative standards as to what is a good merger and what is a bad merger, what is a good investment and a bad investment, seems to be to be a very dangerous game to try to play, one in which I would proceed with great caution.

The free market system has worked well. The allocation of resources in the most efficient manner to those who are willing to pay the highest price for those assets is something that over the years has performed well for this economy on a national and international basis. By handicapping the so-called hostile acquiror, we would be limiting the market for corporate control, and interfering with shareholders realizing the highest values for their shares. Utilizing the tax laws to interfere with the normal functioning of our free market system could have undesirable consequences.

I'm not smart enough to sit here today and say what the negative impact would be, but I do suspect that it would be negative and it would be negative in lots of ways that we cannot even forecast here today.

I would be happy to answer any questions.

[The prepared statement follows:]

STATEMENT OF LOUIS PERLMUTTER, PARTNER, LAZARD FRERES & CO.

Mr. Chairman; members of the committee, the issues you are concerned with today, namely the impact of tax considerations on the acquisition decision making process is important to understand. The manner in which Congress deals with the issues raised by takeovers will influence, in an important way, the manner in which the economy of this country performs in the worldwide marketplace.

I am an investment banker, a partner in the firm of Lazard Freres & Co., whose business is to provide financial advice to large United States and foreign corporations. This is the type of work I have been doing for 18 years, during which time I have represented clients on both sides of the corporate takeover process.

For analytical purposes, it is important to divide takeovers into different categories. First, the public company acquiring another entity; second, an investor acquiring a significant block of a target company's stock, and third, a leveraged buyout situation. In each of these categories, different considerations are important in the decision making process.

In the public company acquisition area, it is generally agreed that there are no universal reasons why a takeover occurs. However, the primary considerations are derived from the general economic and business environment at a point-in-time. Mergers are a symptom of this environment—a reaction to slow growth, poor returns, intense foreign competition. When a Board of Directors decides to proceed with a takeover, in every case of which I am aware, it was after considerable business and financial analysis, with the conclusion that the deal made business sense. Tax considerations are not a motive for doing an acquisition.

Business reasons vary from case to case. Thus, the need to acquire additional technology compelled General Motors to acquire E.D.S., and I.B.M. to acquire Rolm; the need to gain better marketing and distribution clout led Beatrice to acquire Esmark; the ability to acquire assets cheaper by acquisition than internal development led to Socal-Gulf, Texaco-Getty and the other oil deals; the goal of reducing dependence on a mature, declining product line dictated that U.S. Steel acquire Marathon Oil. The list, as we all know, is long. Obviously every decision will not prove to be correct, but the free market process of takeovers, spin-offs, proxy fights,

mergers are part of the essential repositioning of American industry to function more efficiently in a hostile, competitive world marketplace.

After the business decision is made to proceed with a deal, then the financial impact is carefully analyzed. How much will the transaction increase or decrease earnings per share, what will the balance sheet look like—will the acquiror's credit rating be impaired? In light of these considerations, how should the deal be structured—cash, stock, some of both, or some other combination, and where will the money come from, and how will it be repaid?

Once these issues are resolved satisfactorily, taxes are considered. The objective is to structure the deal in the most tax efficient manner. From an acquiror's perspective, in a taxable transaction, the principal concern is whether the assets of the acquired business will have a stepped-up basis for purposes of depreciation and measurement of gain upon a subsequent sale, or have a carry-over basis. Before TEFRA and section 338, many acquisitors utilized the partial liquidation technique to obtain a stepped-up basis in the acquired assets, but without recognizing as income recapture and other tax benefits. However, section 338, which was enacted in 1982, eliminated the use of partial liquidations and imposed the cost of recapture and other tax benefits as items of income. As a result, very few acquisitors now make a section 338 election and step-up acquired assets. The cost of the tax on recapture, which is paid up front, offsets the benefits of higher write-offs taken over a period of time. The economics of present value dictates that the selling corporation's historic basis in assets be retained; therefore, this is how deals are being structured.

Conversely, the principal concerns of the seller are whether the transaction is taxable or not, and if so, whether the gain will be taxable as capital gain or ordinary income.

Simply put, taxes are not a critical issue, are not a motive to do a deal, but once the decision is made to proceed, than taxes become a consideration.

When we analyze motives for a stock market accumulation program in a target company's shares, again taxes are not an important factor. By far the single most important criteria is whether the target company's shares are undervalued in price. In a large public company acquisition the acquiror is an industrialist with business logic for the takeover. In this area the acquiror is a financial entrepreneur with no real desire to control or manage the target himself—rather he would like to create value by starting a bidding contest, liquidating the company, spinning off certain assets or some other similar program. I view this as a healthy process that keeps management on its toes, often resulting in assets being reallocated to the highest bidder or more efficient user. If the business judgment is wrong about the underlying value of the assets, it is the private investor that loses money, not taxpayers. Investors who are not good at identifying undervalued situations will be punished.

In the leveraged buyout business, the primary consideration for doing a deal or not is whether the cash flow of the acquired company is sufficient in amount and stability to service the large amount of debt incurred to finance the transaction. Obviously, in analyzing a proposed L.B.O., taxes are important inasmuch as the ability to write up assets to increase depreciation charges and deduct interest expenses on the acquisition debt are essential elements in determining available cash flow. But again, while taxes facilitate the doing of the acquisition, they are not the reason for doing it. Rather, it is because of the business characteristics of the seller—assets available to be written up and a steady operating history.

Some charge that leveraged buyouts are fueled by tax subsidies. Our tax laws have always permitted a deduction for interest incurred on borrowings to buy stock or real assets, to build a plant and equipment, to develop new products. There is no reason to view a leveraged buyout any differently.

From a public policy perspective, I view mergers, takeovers, proxy fights as a critical part of the birth, growth, decay cycle that inevitably occurs. Obviously, whenever there is change and transition, it causes concern, dislocation, hardships to some participants. But in the aggregate the process is healthy. Under any circumstances changes are going to occur which sooner or later will cause disruptions. I believe we must trust the market on this. If government has a role, it is to deal with the harshness of the free market system by providing job retraining, relocation assistance, by assuring individual survival. But it should not interfere with the working of the market.

As I review some of the recent tax proposals that discriminate against "hostile" takeovers—for example, denying the interest deduction on indebtedness—they are discriminatory, punitive measures designed to protect the status quo. The result is confiscatory to shareholders—preventing them from receiving the highest value they are able to obtain. To date interest incurred on debt to finance expansion has been considered a legitimate business cost. If the interest deduction is disallowed in

so-called "hostile" situations, the acquiror obviously could not afford to offer the same price as one who could utilize the deduction. This results in limiting the market for corporate control and denying the acquired company's shareholders access to a bidder who might place the highest value on their shares if the tax laws were neutral.

There is no compelling evidence to date that hostile transactions produce harmful effects. In the aggregate they produce benefits by moving resources to more efficient users. Income tax laws should not attempt to discriminate between good and bad investors. It is not possible to set legislative standards that will insure that only good mergers take place. The free competitive market is the most efficient regulator, punishing severely those that make poor investment decisions.

The impact of such legislation on the capital markets would be quite adverse. Our markets are the most liquid and efficient in the world. Imposing artificial restrictions on the possibility of realizing maximum returns on investments almost certainly would have undesirable, unintended consequences.

If tax neutrality is the objective, then such legislation as proposed in several pending bills is anything but neutral. Rather, they are needlessly punitive. Further, such proposals are inappropriate as a matter of general tax policy; they are proposed for non-tax reasons. I believe that the Internal Revenue Code is an inappropriate vehicle to ban hostile takeovers.

Chairman PICKLE. We thank you for your statement.

I want to go ahead now and ask for the next gentleman, Mr. Profusek.

STATEMENT OF ROBERT A. PROFUSEK, PARTNER, JONES, DAY, REAVIS & POGUE

Mr. PROFUSEK. Mr. Chairman, my name is Robert Profusek. I am a partner with Jones, Day, Reavis & Pogue, which is one of the 10 largest law firms in the United States.

I am here not in——

Chairman PICKLE. Your firm is Jones——

Mr. PROFUSEK. Jones, Day, Reavis & Pogue.

Chairman PICKLE. You are from where?

Mr. PROFUSEK. I am resident in the Dallas office of Jones-Day, but I am here not in my capacity as a Jones-Day partner, nor are my comments necessarily indicative of the views of the firm or any of our clients. Nor is my residence in Texas indicative of anything, which is probably the only time today that has been true.

Chairman PICKLE. You are not refuting your Texas association, are you?

Mr. PROFUSEK. No; I'm just not involved in the first two panels. [Laughter.]

I, too, have submitted a written statement and would ask that it be entered into the record. I, too, will try to shorten my testimony, given the hour.

I am a lawyer, but I am not a tax lawyer. I am basically involved in the legal side of structuring corporate acquisition transactions.

I would agree with the testimony of the rest of the people on this panel that I do not believe that the tax benefits attributable to the interest deduction, the combination of tax benefits resulting from 338 and 337 treatment, and those kinds of things, which frankly have gotten the greatest publicity and which are the subjects of the pending legislation, really are motivating factors in acquisition transactions.

I am confident that there are some transactions as to which, if the interest deduction were not available, the bidders' management or the acquiring company's management in a friendly deal might

decide that it was not worth it, from an economic risk-reward type analysis. So some marginal acquisition transactions would probably be eliminated if some of the tax attributes were eliminated.

I also think quite a few friendly transactions, and particularly so-called leverage buy outs, which are frequently management participatory transactions, would also be—the number of them would be eliminated, because my experience has been that the margins in those transactions are usually not as great as they sometimes are in at least the initial bid of a hostile bid or the initial offer in a negotiated transaction.

Even recognizing that there would be some impact, I don't think that in any sense it would curb the so-called wave of hostile takeover activity that has arisen in this country, nor the much more prevalent wave of negotiated merger and acquisition activity that exists today.

This entire discussion is spelled out in much more detail in my written statement. I won't belabor what has already been said.

I would like to comment specifically on some of the remarks that have been made by others today on the debt-equity question.

From a lawyer's standpoint, it is difficult to accept some of the suggestions that have made in connection with some of the pending legislation, principally that the interest deduction really propels conclusions on how to finance these transactions.

The mere substitution of debt for equity isn't the kind of decision that is undertaken by any company merely because of the deduction that is available and the lack of deduction—in effect, double taxation—for dividends.

The decision to move to debt is a very difficult one for lots of companies, and it involves all sorts of considerations that were alluded to earlier: the effect of putting additional debt on an operating company can affect its credit rating; it sometimes can be prohibited under existing indentures and other instruments that the company has and, obviously, it has the rather dramatic comparative effect in the sense that it has to be retired, and you have to pay interest on it. If you don't, you've got a business problem.

I think that while analytically—and maybe from an economist's standpoint—you could say that debt and equity are fungible, they really are not in the real world. Companies deal with their debt-to-equity ratios in a fashion as to which, once again, the tax consequences of the difference in the treatment of the payment of dividends or the deduction of interest are important, but they are just one factor in a much more complicated mix of factors.

The last question, that I would just like to discuss briefly is the suggestion that has been made several times about distinguishing as a matter of tax policy between hostile and friendly transactions.

I suppose it is possible to get over some of the definitional issues, but they are difficult ones. I think they will be at least as difficult as some of the other problems that have been caused when, for different reasons, Congress has tried to change the tax law to accomplish particular objectives in the merge area. I am particularly thinking about the golden parachute rules from last year.

Even assuming that the definitional issues can be overcome, I am not at all sure that, as a matter of tax policy, the Federal Govern-

ment has quite made the decision yet as to where it wants to be on hostile takeovers.

Quite clearly, in 1968 there was a decision to be neutral in the process. My personal belief is that the deck is stacked very heavily against the target management in a hostile situation. But, until the policy issues underlying the legislation that Congress is dealing with on these subjects are really resolved directly, I don't see why the tax laws should be changed in a fashion that basically got out in front of these issues as they are being dealt with directly by Congress, particularly the numerous legislative proposals which would either explicitly or by effect have a very significant negative effect on takeovers.

Chairman PICKLE. Do you have a written statement?

Mr. PROFUSEK. I submitted it to the staff.

Chairman PICKLE. We have that?

Mr. PROFUSEK. Yes.

Chairman PICKLE. That will be included, the entire statement. Have you concluded?

Mr. PROFUSEK. Yes, I have.

[The prepared statement follows:]

STATEMENT OF ROBERT A. PROFUSEK, PARTNER, JONES, DAY, REAVIS & POGUE

I. BACKGROUND

My name is Robert Profusek. I am a Partner, specializing in contested takeovers and mergers and acquisitions generally, in the Dallas Office of Jones, Day, Reavis & Pogue.

Jones Day is a national law firm with approximately 450 lawyers located in Austin, Cleveland, Columbus, Dallas, Los Angeles and Washington. Jones Day is actively involved in the provision of legal services to a wide variety of participants in the takeover process. However, the views expressed by me today are solely my own and do not represent the views of Jones Day or any of its clients.

I have been involved for about a decade in advising companies in the planning, initiation and consummation of hostile and negotiated takeovers, in the defense of publicly announced and other takeover bids and proposals and in takeover planning generally. In addition, I have published about a dozen articles concerning a variety of subjects in the takeover area, and have spoken before a number of groups on various takeover topics, including before Congressional Committees and at administrative hearings.

I appreciate the opportunity to appear before the Subcommittee on Oversight as it undertakes the extremely important task of reviewing the extent to which the tax laws influence mergers and acquisitions. I should point out at the outset that I am not a tax lawyer, and as such I am not qualified to speak to technical issues raised by the present tax system. However, the global effects of the present tax system on corporate acquisitions are fairly easily understood, even by the non-tax practitioner. It is to these global effects that my remarks will be addressed.

II. THE CURRENT TAKEOVER BINGE

A. General

Only a few years ago, takeovers and mergers and acquisitions were of interest only to regular readers of the Wall Street Journal. However, in recent years takeovers have earned a regular spot on the evening news with other events of general interest. The reasons for this change are apparent:

(i) The sheer size and number of these transactions: The first $1 billion-plus tender offer occurred only six years ago (Exxon's acquisition of Reliance). Yet by 1984, there were eighteen $1 billion-plus takeovers, and two hundred $100 million-plus takeovers. In total, more than 2,500 takeovers were completed in 1984, involving the staggering sum of $122.2 billion. Almost 75% of all takeovers completed in

1984 involved cash as the acquisition currency, and much of the cash for the transactions was borrowed. [1]

(ii) The evolution of the techniques relevant in this process and wide range of types of bidders and other takeover participants: The available techniques have evolved from the straight-forward tender offer to include "greenmail," "bust-up" proposals, "Wolf Pack" stock accumulations, friendly and unfriendly leveraged buyouts, "bear hugs" and myriad other strategies, and the types of bidders have evolved from the classic "raider" or liquidator to include conservatively managed, blue-chip companies, companies themselves in need of quick fix solutions to internal business or management problems, first-time financiers, bust-up artists, liquidators, greenmailers and others.

(iii) The change in the type of target companies: Hostile takeovers, which are still virtually unheard of in most other industrial countries, have become a common occurrence in the United States, and the targets now include well managed, household-name companies such as Gulf Oil, Shell Oil, Stokley Van Camp, Carnation and even Walt Disney Productions.

It is, of course, hostile takeovers that have attracted the most attention in the popular press, in Congress and among the state legislatures. And it is these transactions that I shall particularly emphasize, because it is developments in that context which best demonstrate the most direct and recurring impact of the tax laws on acquisitions generally and suggest the areas as to which legislative reform might be desirable.

B. The hostile takeover environment

During the 1950's, contests for control of publicly owned companies generally involved competing proxy solicitations in which only control of management of the target, not ownership of its assets, was at issue. However, with the conglomeration movement of the 1960's, tender offers became almost as prevalent in the United States as they had been in England during the immediate post-War period.

During the 1960's, takeover bidders were normally viewed as "raiders" intent on obtaining access to the target's assets to liquidate them in whole or in part. Thus, when Congress first took up the subject of regulation of takeovers, the sentiment was quite clearly to protect target company management and to inhibit takeovers generally. [2] However, by the time that the Williams Act was enacted in 1968, this one-sided approach was rejected in favor of a system of federal regulation that did not "tip the balance of regulation either in favor of management or in favor of the person making a takeover bid", [3] because of a Congressional perception, fomented largely by the professional investment banking community and Chicago-School economists, that takeovers were fundamentally good, that they acted as a necessary check on "incumbent management" and that they therefore should not be discouraged.

While many, including representatives of the Reagan Administration, [4] continue to argue against the erection of legislative barriers against takeovers, few experienced practitioners would disagree with the proposition that the hostile takeover bidder now holds most of the cards. The bidder plans and acts in secrecy without, usually, any substantial advance warning. If a public or major private company, the bidder seemingly has access to unlimited debt financing from banks; if a takeover entrepreneur, even one operating through a shell company, "junk bond" financing can be available for virtually any size of transaction. [5] The stockholders of a public company are often interested only in maximizing their immediate return on their investment and not in the long-term growth of the company through research and development of its assets. As a result of this narrow focus by individual investors, accentuated by the increasing institutionalization of equity ownership, [6] after the announcement of a bid, or the express or implicit threat of one by a Schedule 13D filer, arbitrageurs and other speculators quickly dominate the market for the target's stock, drive up the price of the stock and frequently end up owning, in the aggregate, a controlling interest in the target. These new stockholders, who will

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[1] *See* W. T. Grimm & Co., *Mergerstat Review* (1985) *("Grimm 1984 Statistics")*.

[2] *See, e.g.*, S. 2731, 89th Cong., 2d Sess. (1966); S. 510, 90th Cong., 1st Sess. (1967).

[3] S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967).

[4] *See, e.g., Economic Report of the President* 187-215 (1985) *("President's Report")*.

[5] *See, e.g., Corporate Control Alert*, Mar. 1985, at 2, col. 1 ("Drexel's apparent ability to raise financing for Icahn's bid for Phillips has given credibility to its claims that it can finance almost anything.").

[6] For example, 86% of institutional stockholdings, worth some $600 billion, are administered by a group of about 100 financial institutions. *See* Testimony of R. M. Soldofsky before the U.S. Dept. of Labor (Jan. 15, 1985).

have almost invariably financed their purchases with borrowed funds, will have only one interest: to ensure that the company is taken over, as quickly as possible, so that they can escape with their precalculated spread on their leveraged investments. Finally, the Williams Act presently imposes no meaningful limitations on the bidder and, with but a few recent exceptions, state corporation and Blue Sky laws are no real obstacle. [7] (Indeed, perhaps ironically, state laws may serve only to limit the range of the target's possible defenses. [8]

Recent statistics demonstrate that targets resisting an actual bid remain independent only about 25% of the time, [9] and their success in so doing appears to bear no significant relationship to the fairness of the bid price. [10] Instead, once a target is "put in play," in most instances its only real recourse is either to look for a White Knight, to "greenmail" the bidder, or to adopt other potentially costly defenses (such as the issuance of "poison pills" or blocking preferred stock, sales of "crown jewels", defensive acquisitions, massive market repurchase programs and similar measures). This is so whether or not the target's board of directors (which is normally comprised of a majority of outside directors), acting in good faith and without any real taint of self-interest, has concluded that the takeover bid does not reflect the intrinsic value of the target, may be illegal or may damage legitimate interests of non-stockholder constituents of the Company.

In short, for better or worse, the Williams Act's ideal of a "level playing field" between bidder and target is a mere pipedream. As a result, a barrage of legislation is now pending in Congress, much of which would significantly inhibit takeovers. [11] The desirability of such legislation has been the subject of much debate. [12] Thus, the basic questions of whether takeovers are good or bad, what constituencies should be protected and how, and whether federal legislation should be enacted to inhibit these transactions are squarely before this Congress. Therefore, it is appropriate for this Subcommittee and Congress as a whole carefully to analyze existing legislation and the current acquisition environment to establish over-all goals for any legislation which may impact the takeover process and, having established such goals, to determine whether and to what extent it is appropriate to revise the federal income tax system to achieve the desired results.

III. THE IMPACT OF THE CURRENT FEDERAL INCOME TAX SYSTEM ON MERGERS AND ACQUISITIONS

The current federal income tax system significantly affects the takeover and merger and acquisition process. For example, tax-loss or depreciation-rich taxpaying entities frequently seek high-tax-rate counterparts as acquisition targets so as to bring tax value to a combined entity, and high-tax-rate acquirors frequently seek tax-benefit-rich targets to reduce their combined tax rates. Negotiated acquisition transactions, even those involving a substantial amount of cash, are frequently structured as tax-free reorganizations so that, among other reasons, low-basis target stockholders may participate in the transaction without adverse tax consequences. Stock and asset transactions may also be structured as installment sales to permit the sellers to defer recognition of a portion of the gain on the transaction, and the incredibly intricate series of tax rules which can apply to securities received in a corporate reorganization frequently comes into play. [13]

A host of bills has recently been introduced in the House of Representatives and the Senate which would, among other things, impose an excise tax on the receipt of "greenmail" and deny the paying company any deduction therefor, [14] require a

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[7] *See, e.g.*, Profusek & Gompf, *State Takeover Legislation After MITE: Standing Pat, Blue Sky, or Corporation Law Concepts?*, 7 Corp. L. Rev. 3 (1984).

[8] *See, e.g., Norlin* v. *Rooney, Pace, Inc.*, 744 F.2d 255 (2d Cir. 1984). *See generally* Huber, Remarks Before ABA Sec. of Corp., Bank & Bus. L. (Apr. 7, 1984), *reprinted in Legal Times*, Apr. 23, 1984, at 35, col. 1.

[9] *See, e.g., President's Report* at 207.

[10] Of the 38 companies that successfully resisted hostile takeover bids during the period from 1973 to 1982, the stock of about two-thirds of them have subsequently traded at a higher price than the hostile bid price. Kidder, Peabody & Co., *Summary of Defeated Hostile Tender Offers 1973-1982* (1983).

[11] *See, e.g.*, H.R. 1480, 99th Cong., 1st Sess. (1985) (which would, among other things, require the approval of the stockholders of both the bidder and target before a tender offer would be permitted); S. 631, 99th Cong., 1st Sess. (1985) (essentially to the same effect).

[12] *See, e.g.*, Hearings before Subcomm. on Tele., Consum. Protec. and Fin., House Comm. on En. & Com., 99th Cong., 1st Sess. (Feb. 27, and Mar. 12, 1985); *Wash. Post.*, Mar. 13, 1985, at D-1, col. 1; *Wash. Post*, Mar. 5, 1985, at D-1, col. 1; *Los Angeles Times*, Nov. 11, 1984, at B-1, col. 1.

[13] *See generally* B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* 14-3 to 14-192 (4th ed. 1979).

[14] *See, e.g.*, H.R. 1100, 99th Cong., 1st Sess. (1985).

mandatory Section 338 election and deny the availability of Section 337 treatment for liquidations in hostile acquisitions, [15] and deny the Section 163 interest deduction with respect to subordinated debt obligations (so-called "junk bonds") [16] or with respect to any other financing incurred in connection with hostile takeovers. [17] The premise of these legislative proposals appears to be that changes in the tax laws are required either to thwart the "barrage of corporate takeovers that is blasting its way through corporate America" [18] or at least to make the tax system neutral. [19]

As I indicated at the outset, the present tax system is a significant factor in the current wave of takeovers and mergers and acquisitions. However, in my view the tax laws are only one element of a complex mix of factors which have come together to cause the level of acquisition activity that presently exists. The significance of the two tax provisions most cited as contributing to this level of activity—the stepped-up basis benefits provided by Section 338 of the Internal Revenue Code and the interest deduction permitted by Section 163 of the Code—will be briefly explored next.

A. Section 338

Under Section 338, an acquiring company may elect to buy the stock of the target in a taxable transaction but treat the acquisition as if it had purchased all of the target's assets. The acquiring company is thus permitted to step-up the bases for the target's assets to the lesser of the acquiror's purchase cost and the fair market value of the assets. While the acquiring company may have to pay recapture taxes on tax benefit items such as investment tax credits, depreciation and depletion previously taken by the target, [20] the acquiror can usually achieve a significant economic advantage not available to the target as an ongoing public entity by increasing cash flow because of its ability under Section 338 effectively to redepreciate and redeplete the written-up assets in a purchase transaction.

The disparity of values available to the acquiring company and its present owners can be substantial. Existing stockholders cannot directly realize the gain in tax-basis appreciated assets without a sale of the assets by the company, or an in-kind distribution to stockholders, both of which require the payment of both recapture tax and tax on the appreciation by the distributing company (unless the company were totally to liquidate within one-year under Section 337). The problem is, in fact, compounded by the double taxation phenomenon. In-kind distributions are rare and to a substantial degree impractical in most circumstances, leaving the company as the only truly viable legal person actually to capture the gain. Subject to the partial dividends-received deduction, such gains cannot, of course, be distributed to stockholders without double taxation.

Thus, on a cash-flow basis, which is the key analysis undertaken in most takeovers, the target may well be much more valuable to an outsider than to the company itself. This economic phenomenon is to some degree responsible for the recent proliferation of leveraged buy-outs ("LBOs") and bust-up proposals, as well as the enormous consolidation trends in asset-intensive industries such as the oil and gas, financial institutions and real estate industries. One sometimes overlooked aspect of this phenomenon is, of course, that taxpayers in essence bear a substantial part of the economic cost of such transactions by the lower corporate taxes payable as a consequence of increased levels of depreciation and depletion.

However, as I suspect most practitioners in this area would testify, it is doubtful that the basis step-up provisions of Section 338 are a motivating force behind the current wave of takeover activity, at least hostile transactions. A 1% stockholder has a statutory right to the company's prior tax returns (without having to notify the company). [21] However, when the economic feasibility of a hostile takeover bid is being determined, the prospective bidder normally does not have sufficient knowledge of the tax bases of the target's assets which the bidder might dispose of, nor can it know with any degree of certainty how much of the purchase price properly can be allocated to low-basis assets. Thus, at least in hostile takeovers, the Section 338 tax benefit is often discounted to a significant degree.

Estimates of Section 338 basis step-up values and the increased cash flow resulting therefrom are, of course, taken into account in the pricing of hostile transactions. But many other considerations are of equal relevance in pricing. And factors

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[15] *See, e.g.*, H.R. 1003, 99th Cong., 1st Sess. (1985).
[16] *See, e.g.*, H.R. 1100, 99th Cong., 1st Sess. (1985).
[17] *See, e.g.*, S. 632, 99th Cong., 1st Sess. (1985).
[18] Cong. Rec. S2789 (daily ed. Mar. 7, 1985) (remarks of Sen. Chafee).
[19] *Id.* at S2791.
[20] *See* 26 U.S.C. §§ 47, 1245 & 1250.
[21] *See* 26 U.S.C. § 6013(a)(d)(iii).

other than pure economic maximization of the value of the target's assets, such as market and management synergies and business diversification, frequently play a major role in the decision to initiate a takeover bid. Thus, while significant especially with respect to depreciation- or depletion-oriented businesses, Section 338 benefits are not, in my judgment, motivating factors. Indeed, the effect of eliminating them in hostile transactions, while perhaps preventing some financially marginal transactions from being initiated in the first instance, might very well have only the general effect of reducing the average premium paid to stockholders in most takeover transactions.

Not surprisingly, the result may well be different in negotiated transactions, especially LBOs. As I will discuss in more detail later, LBOs are often more fully priced than the initial bids in hostile takeovers and the tax benefits available to the acquiror are frequently an important factor in price negotiations in friendly acquisitions. Thus, the elimination of the Section 338 election would probably very significantly reduce the number of LBOs and negotiated acquisitions or, again, reduce the consideration offered to stockholders in those transactions.

Perhaps for this reason, many of the legislative proposals presently before this Congress would modify the application of Section 338 only in hostile transactions. For example, Senate Bill 362 [22] applies the new tax treatment only to acquisition transactions that are not approved by a majority of the independent directors of the target company. However, with such a limitation on its application, enactment of the new tax treatment may achieve results which are neither intended nor desired.

The distinction between a hostile and friendly transaction is frequently illusory. To be sure, an unsolicited "Saturday Night Special" tender offer resisted by the target is easily identified as a "hostile" transaction. However, "bear hug" bids, White Knight acquisitions following "Wolf Pack" stock accumulations by stock speculators and similar takeover phenomena are in reality no less hostile, and present most of the basic policy issues raised by more classic raids. Moreover, even if the proposals could be drafted to limit their application to actual hostile takeovers and, by so limiting their application, could be drafted so as not to be susceptible of easy avoidance, it is difficult to support any distinction between hostile and friendly takeovers as a matter of tax policy. Unless Congress is prepared to conclude, as a matter of general federal policy, that hostile takeovers generally should be discouraged, an important Internal Revenue Code distinction between hostile and friendly transactions simply cannot be justified. In short, the availability of Section 338 benefits (and Section 337) in hostile takeover transactions should, in my opinion, be evaluated in the context of Congress' overall evaluation of whether these transactions should be discouraged.

If the purpose of tax revision in this context is, however, to take steps to restore some semblance of neutrality to the takeover process, some legislative changes can perhaps be justified. Denial of the Section 338 election to hostile acquirors, or permitting the target itself to step-up its basis prior to sale, would put the bidder and target on the same footing, but the cost of so doing seemingly cannot be justified as a matter of tax policy alone. The Treasury Department's recent proposals to reduce or eliminate investment tax credits and replace ACRS depreciation with RCRS also would help eliminate the tax disparity between the outside acquiror and the target and its current stockholders. However, this would not completely eliminate that disparity in an even moderately inflationary economy since the difference between the intrinsic value of any asset and its tax basis is only partially made up of prior basis reduction items, and back-end loading of tax benefits would obviously negatively affect many corporate taxpayers completely outside the takeover context. Thus, if the Treasury's proposals are adopted it should not be based upon the takeover implications thereof.

B. Section 163

Cash has become the preferred consideration in most acquisitions, and most banks and other financial institutions have long since shed their reluctance to provide funding for hostile takeover offers. Recent transactions have shown that cash can be readily borrowed to finance friendly or unfriendly acquisitions.

What appears to some to be unsettling in the current context is the ready availability of debt financing for leveraged buy-outs since in these transactions the target company's equity capital is in large part replaced by straight or convertible debt. What has become even more unsettling is Wall Street's ability to raise enormous amounts of cash for both blue chip bidders and takeover entrepreneurs by the issuance of high-coupon, subordinated "junk bonds", usually to institutional investors

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[22] 99th Cong., 1st Sess. (1985). *See* Cong. Rec. S2789-93 (daily ed. Mar. 7, 1985).

and other financial intermediaries. Since the emergence of the junk bond market in the late 1970's, more than $30 billion of these securities have been sold to the public. [23] While only a portion thereof has been used to finance hostile takeovers, Drexel Burnham Lambert Incorporated's ability to obtain commitments for $1.5 billion in junk bond financing for Carl Icahn's since-abandoned bid for Phillips Petroleum demonstrates the potency of this financing technique. [24]

Finally, arbitrageurs and many other takeover speculators run their investment activities almost entirely on debt financing. And, as indicated above, it is the interest costs which they incur which in large part require that they act to ensure that the companies in which they invest are sold as promptly as possible, most preferably for cash.

Under Section 163 of the Internal Revenue Code, virtually all interest costs incurred in connection with the acquisition of stock or assets are deductible by the acquiring company. Accordingly, it has been suggested that the elimination of the interest deduction would greatly curtail the current takeover binge. [25] I doubt that, at least as a general proposition.

Like Section 338, the tax benefit in the Section 163 interest deduction does, of course, have real economic significance. As such, the interest deduction on debt financing is assigned a value by potential acquiring companies in analyzing particular acquisition possibilities, whether financed with bank loans, junk bonds or other debt. If the interest deduction were not available for acquisitions, it might have the effect, for companies which could not refinance the debt with equity on terms reflecting the value generated by the transaction, of discouraging acquisitions of particular companies merely by reducing the potential returns on the acquisition to a point at which the economic risk-reward analysis does not justify the transaction.

However, in many acquisitions the risk-reward analysis is not so narrow that the loss of the economic benefits of the borrowing costs for the transaction would be determinative. The potential profit margins in takeovers are frequently much greater, as the frenzied auctions which frequently follow initial tender offers demonstrate. The multiple bidding for Conoco in 1981 is illustrative:

5/6/81—Dome Petroleum bid $65 per share for approximately 20% of Conoco's stock.

5/25/81—Seagram bid $73 per share for approximately 40% of Conoco's stock.

7/16/81—DuPont agreed to acquire all of Conoco's stock at a blended price of $80 per share.

7/17/81—Seagram counterbid $85 per share for 51% of Conoco's stock.

7/14/81—DuPont raised its bid to a blended price of $85.81 per share.

7/17/81—Mobil bid $90 per share for all of Conoco's shares.

7/23/81—Seagram countered at $92 per share for 51% of Conoco's stock.

7/27/81—Mobil increased the cash portion of its bid to $105 per share (51%) plus securities at $85 per share for the remainder.

8/3/81—Mobil increased the cash portion of its bid to $115 per share.

8/4/81—DuPont increased its bid to $98 per share (45%) plus securities at $77 for the remainder and won the contest notwithstanding Mobil's last-ditch bid at $120 cash for 51% of Conoco's stock. [26]

Strong policy arguments can be made that the dramatic increase in debt-financings for corporate takeovers is having the dangerous effect of the over-leveraging of corporate America and negatively affecting the availability of credit for more productive corporate uses. [27] However, persuasive contrary empirical evidence also exists. [28] Moreover, as discussed earlier, while the elimination of the Section 163 interest deduction would likely eliminate certain takeovers, it is not likely that it would significantly limit the number or size of bank- or junk bond-financed hostile transactions.

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[23] *See generally* Hearings Before H. Com. on Ec. & Comm., 99th Cong., 1st Sess (Feb. 27, 1985) (remarks of F. Joseph).

[24] *See, e.g., Corporate Control Alert,* Mar. 1985, at 2, col. 1.

[25] *See,* e.g., Cong. Rec. S3789–93 (daily ed. Mar. 7, 1985) (remarks of Sen. Chafee).

[26] Numerous other examples of multiple bidding do, of course, exist. For example, on October 19, 1979, AMCA International bid $57 per share for Warner & Swasey; Bendix bid $70 per share on December 13, 1979; AMCA recountered at $75 per share on December 14, 1979 and on the same day Bendix topped AMCA at $83 per share. Likewise, Mobil's initial offer for Marathon Oil of $85 per share was topped by U.S. Steel's cash price of $125 per share (51%), after which Mobil recountered at $126 per share (51%).

[27] *See, e.g.,* SEC Comm'r Shad, "The Leveraging of Corporate America," remarks before the New York Financial Writers Association (June 7, 1984).

[28] *See, e.g.,* SEC Advisory Comm. on Tender Offers, *Final Report,* Rec. No. 2 (July 8, 1983).

The elimination of the interest deduction would, in my judgment, probably have a greater effect on LBOs. Perhaps due to the conflicts-of-interest said to be inherent in some of such transactions, and to ward off competitive bids, LBOs tend to be more fully priced than other acquisition transactions. In 1984, there were 57 completed LBO transactions involving an aggregate of more than $10.8 billion, compared to 36 of such transactions totalling $7.1 billion in 1983. However, 34 other LBO transactions involving an aggregate of $19.5 billion were announced in 1984 but not completed (the comparable 1983 figures being seven transactions and $2 billion). The failure of financing was cited as the reason for most of the terminated transactions. [29]

The price sensitivity of LBOs is also evidenced by certain consequences of the Deficit Reduction Act of 1984 ("DEFRA"). Under DEFRA, interest paid by employee stock ownership plans is subject to a partial exclusion from the income of certain lenders, thus permitting the lender to lower its actual interest rate and receive the same effective after-tax yield that it would have received from a non-ESOP borrower at a higher rate. The existence of this economic savings has encouraged the use of ESOP-LBOs, both in terms of complete acquisitions and as defensive measures. In short, a difference of a few points on financing could affect the viability of LBOs generally because of the extent to which those transactions are fully priced.

Unlike the issues discussed earlier relating to Section 338, the elimination of the interest deduction for the actual participants in the takeover process seemingly cannot be justified on neutrality grounds. While the cumulative effect of modifying Section 338 treatment in hostile takeovers and the elimination of the interest deduction on debt financing could have a significant effect, in my opinion the greatest impact would be on negotiated transactions and LBOs. And, for the reasons discussed earlier, even if feasible, the singling out of hostile transactions for special treatment seemingly cannot be justified as a matter of tax policy alone.

On the surface, it would appear that the elimination of the interest deduction for the carrying of securities in arbitrage and other stock market speculation could have a significant effect. With the "Wolf-Pack" and other recent marketplace phenomena, the distinction between true arbitrage and direct takeover participation has tended to blur in the past several years. However, the use of borrowed funds for takeover speculation by professional and amateur arbitrageurs is a key element in the reality that relatively few companies that are "put in play" can remain independent without resorting to exotic and/or costly defenses.

It could perhaps be argued that arbitrageurs and stock market speculators should not be permitted effectively to make decisions that affect vital interests of many constituents of American corporations based solely upon computations of the spread between their borrowing cost and an anticipated cash-out price. However, the stock market activities of arbitrageurs merely permit longer-term investors to realize some of the premium promised in a proposed takeover bid, with the arbitrageur being compensated by being permitted to retain the remainder of the gain for bearing the risk that the proposed takeover will not be completed. [30] If the interest deduction were not available to arbitrageurs and takeover speculators, the loss of the tax benefits therefrom would likely become merely an element in their pricing strategy, with the net result being that market prices would not be run up as close to the bid, or expected bid, price as they are today after a target company has been put in play. Thus, eliminating the interest deduction for arbitrage borrowings would, in my opinion, not have a significant deterrent effect on hostile takeovers and in fact would predictably have the negative effect of providing many longer-term stockholders less value for their shares in takeover situations.

C. A final comment on anti-greenmail tax legislation

Virtually no company which has been confronted with the necessity of so doing has relished the prospect of paying "greenmail". Depending, of course, on the particular facts and circumstances at issue, the payment of greenmail may be an entirely proper and lawful exercise of business judgment [31] and, indeed, the only

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[29] *See Grim 1984 Statistics.*

[30] These risks can be substantial. For example, it has been estimated that the arbitrage community lost nearly $100 million as a result of Mesa Petroleum's settlement with Phillips Petroleum. *See N.Y. Times,* Dec. 27, 1984, at D–15, col. 1.

[31] *See, e.g., Cheff* v. *Mathes,* 199 A.2d 548 (Del. 1964); *Kaplan* v. *Goldsamt,* 380 A.2d 556 (Del. Ch. 1977); *Alpert* v. *28 William St. Corp.,* 478 N.Y.S.2d 443 (N.Y. Sup. Ct. 1983); *Lewis* v. *Kurshen,* Civ. No. 13933 (N.Y. Sup. Ct. Nov. 21, 1983); *Karfunkel* v. *U.S. Life Corp.,* 455 N.Y.S. 2d 937 (N.Y. Sup. Ct. 1982), *aff'd mem.,* 469 N.Y.S. 2d 1020 (App. Div. 1983).

viable alternative to a public company. However, the activities of the regular greenmailer benefit nobody but the greenmailer.

Last session, Congress thought it desirable to impose an essentially punitive excise tax on "excess parachute payments." [32] In a similar vein, it might be argued that special tax legislation is warranted to discourage the greenmailer from commencing a massive market accumulation purchase program or unimplied or explicit takeover threat in order to extort a benefit not available to stockholders generally. Based upon this reasoning, a number of bills have been introduced in the current session of Congress which would impose a punitive excise tax on the recipient of greenmail payments and would deny any deductions therefor to the paying company. [33]

While I am, in general, personally sympathetic to the instincts underlying efforts to eliminate greenmail payments, I believe that they should be resisted. First, even assuming that the serious definitional issues presented by the proposed anti-greenmail tax bills could be overcome, reducing but not eliminating greenmail profits would likely only reduce but not eliminate the practice. Moreover, the effect of imposing a punitive tax might well be detrimental to stockholder interests because it may simply cause the greenmailer to insist on a greater premium to make up all or a substantial portion of any new tax. There are a number of situations in which so-called greenmail may be the only responsible alternative for the board of directors of a public company, however, undesirable in the abstract, and it would be decidedly inappropriate for the tax laws effectively to increase the costs of these transactions to those companies. Finally, a substantial number of companies, including Mobil, Arco, Burlington Industries, NCR and others, have recently proposed charter amendments which, by requiring prior stockholders approval of greenmail payments, are intended to discourage greenmailers from initiating those transactions. It is my belief that this phenomenon is better addressed in this fashion than as a matter of tax policy.

I would be pleased to respond to any questions from the Subcommittee.

Chairman PICKLE. Mr. Keilin.

STATEMENT OF EUGENE J. KEILIN, GENERAL PARTNER, LAZARD FRERES & CO.

Mr. KEILIN. Yes. Thank you, Mr. Chairman.

My name is Gene Keilin. Like two of my collegues on the panel, I am a New York investment banker, although I was born and raised in Texas and I am proud of it.

Chairman PICKLE. You may proceed.

Mr. KEILIN. Thank you, sir.

Although I do feel like the last batter in a ball game that is about to be called because of darkness.

Like my colleagues, I have also prepared a written statement which I have submitted for the record.

Like them, I agree the tax considerations are rarely a motivating factor in merger and acquisition transactions, but my topic and the thing I can add to this discussion concerns an aspect of the tax law which plainly does influence the shape and the beneficiaries of some large corporate transactions. That is the subject which has not been much discussed today, although it recently has come into fashion as a technique in transactions between large companies. That is the employee stock ownership plan or ESOP.

As the committee knows, the ESOP has a number of special tax characteristics, the most prominent of which is that a contribution which a company makes to an employee stock ownership plan is deductible. In some cases the employee stock ownership plan can

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[32] *See, e.g.*, Sections 280G and 4999 of DEFRA.

[33] *See, e.g.*, H.R. 1100, 99th Cong., 1st Sess. (1985); S. 632, 99th Cong., 1st Sess. (1985).

use that contribution to repay a loan which has been made to acquire the stock.

In recent years the ESOP has become increasingly used and usable in transactions between large corporations. It was included in the original recapitalization plan of Phillips Petroleum. It was included in a plan recently put forward by National Can and in other corporate transactions.

Obviously, the use of an ESOP, in addition to its tax benefits and characteristics, has considerable impact on who winds up with ultimate control and ownership interest in the affected corporation.

Although most of the ESOP's which have received a lot of attention recently have arisen in connection with takeovers, hostile or friendly, of large corporations, which have made a lot of news and which have come in for some criticism, I would like to spend just a couple of minutes on one ESOP which was also used in a very large and important corporate transaction but which has come in for very little criticism.

Three years ago I became the financial advisor to a group of management and union employees at the Weirton Division of the National Steel Co., who had been told that if they didn't find a way through an ESOP to buy their company it was going to be shut down and they were going to lose their jobs.

In the end, the employees succeeded through the use of an ESOP in buying the company and became in that act the only employee-owned company in the steel industry and the largest employee-owned company in the United States. This was a major transaction. Weirton is a billion dollar corporation and a member of the Fortune 300.

It is also a transaction which both sides plainly benefited, National Steel by disposing of an unwanted facility, the employees by keeping their jobs and by accruing the ownership of their company. Indeed, the results have vindicated their decision. Last year the Weirton Steel Corp. made $60 million from its steel operations after tax, and it was the only major steel company in the country to report a profit of any kind from steel operations. This year it is likely to repeat that result as well.

One characteristic of this transaction which is of interest to this committee is this: the Weirton deal and deals like it could not have been done and would not have been done but for the tax benefits that are available to ESOP's. There are two reasons for this.

One is a company like Weirton and other companies in similar industries need every dollar of profit which they can muster to reinvest in their capital facilities and to become competitive in a world environment.

The second reason is that in a situation like Weirton and other similar situations, if a company is going to become competitive, the employees are going to have to take a reduction in labor cost. They would be reluctant to take that reduction in labor cost if a part of the reduction were paid over to the Federal Government in the form of taxes.

In any event, the business plan of companies in these circumstances isn't likely to work unless they have the advantages which the ESOP mechanism offers to them.

If there was ever a case for which the special ESOP provisions in the Tax Code were designed, Weirton is that case: 100 percent employee ownership, collectively bargained and freely assumed, to save the business and reap its rewards for the employees.

Having said that and having that the Weirton case is an important case and perhaps a precedent for others to follow, I would say as well the following:

First, the merits of the special tax treatment for ESOP's, like the question of deductibility of interest generally or other tax questions, can be debated, but I do believe that a change in the rules concerning the ESOP's would have a significant effect on the transactions to which they now apply.

As I said earlier, and firmly believe, the Weirton transaction would not have occurred and Weirton Steel would not exist today without that tax benefits available to it as an ESOP.

Second, as a consequence, I would approach any change in the ESOP rules with great caution. I believe Weirton to have been an important transaction not only because it preserved 8,000 jobs, but also because it is designed to modernize and strengthen important industrial capacity which would otherwise be abandoned.

Third, once the tax benefits for a Weirton-type ESOP are established, it is difficult to draw the line at other transactions. If there is abuse in the use of ESOP's in some corporate transactions, I believe it lies elsewhere, not in the tools that are available, but in the use to which those tools are put.

Fourth, I would say, if there is, in fact, abuse specifically related to employee stock ownership plans in corporate transactions, I believe it may be of two kinds, and I am not sure there is abuse.

First is the piling up of corporate debt which may leave the employee beneficiaries with a weaker company than the Internal Revenue Code intended for them.

Second, the use of an ESOP to acquire control and to take actions which are not in the interest of minority shareholders.

I think a remedy for these abuses, if they exist, lies in other areas of the law than in the Tax Code. In particular, I believe it lies in the area of securities regulation and it can be found in the possible uses and need for informed consent. I certainly believe that in the Weirton case, at a minimum, if an ESOP is established, either because it has been bargained by the employees or with their informed consent, if they have assumed its benefits and also its burdens, it is one which the tax law should not question.

I am not an idealogue about employee ownership plans any more than I am about mergers and acquisitions. I learned about employee ownership plans when they presented a practical solution to a practical problem at Weirton.

I am currently engaged as an investment banker in other similar projects whose completion is important to my clients. I believe many of them serve important objectives of public policy as well, and they merit your interest and your support.

[The prepared statement follows:]

STATEMENT OF EUGENE J. KEILIN, GENERAL PARTNER, LAZARD FRERES & CO.

EMPLOYEE STOCK OWNERSHIP PLANS: WOLVES IN SHEEP'S CLOTHING?

Mr. Chairman; Members of the Committee, I am an investment banker, not a tax expert. I have, however, learned a great deal about the tax law in one particular area: employee stock ownership plans, or ESOPs, as they are often called. Once, ESOPs were the sleepy preserve of employee benefit experts, but they have recently been in the news for their key role in a number of important corporate transactions. Thank you for the opportunity to testify concerning their uses and potential abuses.

Three years ago I became the financial advisor to the employees of the Weirton division of the National Steel Company who were seeking to buy their mill in order to save their jobs. As many of you know, this novel and courageous effort by the workers eventually succeeded. The Weirton Steel Corporation became the first employee-owned company in the steel industry and the largest company in the United States wholly owned by its employees.

On any scale, this was a major corporate transaction. Weirton is a billion dollar business, a Fortune 300 company, and a member of the exclusive club of major integrated steel makers. Moreover, unusual among major business deals in recent years, this transaction has few if any serious critics. National Steel divested itself of a money-losing business, avoided large potential liabilities, and saw its stock price rise as a consequence. The purchasers acquired a major facility for a bargain price, and have seen their investment decision vindicated by results: last year, Weirton had after-tax earnings of more than $60 million, the only major steel maker to make money from its steel operations. This year, the company's success will be repeated; for the first quarter, Weirton is again the only integrated producer in this country to expect a profit from steel.

One other characteristic of this transaction is unusual: I am quick to acknowledge that the deal could not have been done, would not have been done, but for the tax benefits available to ESOPs.

There are two reasons for this conclusion. First, Weirton's competitors in the steel industry all have large net operating loss carryforwards. National steel is no exception, but the tax benefits of its losses could not have been transferred easily to the buyer. Thus, Weirton's profits would have been subject to far greater taxes than the earnings of its competitors. By the nature of the case, Weirton's competitive position was difficult, and it needed every nickel of earnings to reinvest in more modern equipment. Without the tax benefits available to ESOPs to compensate for the tax shelter already available to its competitors, Weirton's business plan would have made little sense.

Perhaps even more important in the circumstances, Weirton would not have been viable without significant reductions in its labor costs. In particular, Weirton reduced its labor costs by 32%, and much of this reduction came out of the employees' own pockets. The employees came to understand that these sacrifices were necessary in order to produce profits; that profits were necessary in order to invest in the mill; that investment in new facilities was the key to long-term survival. However, I do not believe the employees would have cut their wages if they believed a part of the wage cut would flow to the United States government in the form of corporate income taxes. Whatever the employees might have done, we would not have urged them to go forward unless all of the foreseeable profits in the early years were sure to be reinvested in the mill.

I hope it is plain that the Weirton employees did not buy the company in order to take advantage of the tax benefits available to ESOPs. At best, they were unwilling buyers. But, when they were forced to consider employee ownership to save their jobs, they discovered that the plan could not work without the tax benefits available under current law.

Indeed, recognition of the need for these benefits was so strong that the employees modified the plan they preferred to maximize the tax benefit: rather than distribute equal shares of stock to all employees, they agreed to distribution in proportion to earnings, because this form of distribution maximizes the after-tax earnings which will be invested in the business.

If there was ever a case for which the special ESOP provisions in the tax code were designed, Weirton is that case: 100% employee ownership, collectively bargained and freely assumed, to save a business and reap its rewards for the employees.

As it happens, Weirton took advantage of only two of the four principal tax benefits available to ESOPs under current law. Just for the record, those benefits are the following:

(1) A contribution to the ESOP, like a contribution to a pension plan, is not taxable to the employee at the time of the contribution. Taxation is deferred until the plan distributes the stock, and special tax provisions may be available at that time.

(2) Contributions made to an ESOP are deductible by the employer. If the employer contributes stock to the ESOP, the value of the stock is a deduction. The ESOP can also borrow money to purchase stock, and the employer can make a contribution to repay the loan. Since that contribution is also deductible, the ESOP is perhaps the only device known to the tax law which effectively permits a tax deduction for the payment of principal on a loan.

(3) If an ESOP borrows money to purchase stock, half of the interest on the loan paid to a bank or other lending institution is exempt from taxation. This makes the loan the same as a tax exempt municipal loan, at least to the extent of half the interest, and should result in lower rates to the borrower.

(4) Owners of closely held corporations who sell at least 30% of their stock to an ESOP can defer the gain on the sale if they reinvest in other corporate securities within a specified period. This provision was designed to permit family run businesses, which are often difficult to market, to realize the value of their ownership when the founder is ready to retire.

These tax advantages apply to all ESOPs which meet certain qualifications, not just to those, like Weirton, where the employees own all of the stock.

Indeed, while the employees were bargaining for their economic lives at Weirton, a number of other transactions were being put together which also involved ESOPs. These transactions could not seem more different. The companies were thriving. The management and other investors thought the companies so strong that they could comfortably carry large amounts of debt and still produce a handsome return. In short, these companies were candidates for leveraged buy-outs.

Any calculation of a leveraged buy-out is extremely sensitive to the amount of cash which can be generated. For borrowers and lenders in a buy-out, any reduction in tax increases the feasibility of the buy-out.

As I mentioned, an ESOP can purchase stock with borrowed money, and the loan can be repaid by the company through annual tax-deductible contributions to the ESOP. In effect, a loan made to an ESOP is repaid by the company in pre-tax dollars.

This characteristic of an ESOP increases the amount of cash available to service the acquisition debt: by reducing taxes, the ESOP is an extraordinarily efficient device for increasing the amount of leverage which a company can handle, or making it easier to service a given amount of debt.

A number of leveraged buy-outs have been accomplished which include an ESOP as a major element. Because these ESOPs were initiated by management and outside investors, some questions were raised about their propriety. In particular, the U.S. Department of Labor, which shares supervision of ESOPs with the I.R.S., looked very closely at some of these ESOPs, and used them as an opportunity to make new rules for the protection of employee-beneficiaries. Some of these rules make sense, and some do not, but that is not today's subject.

Since ESOPs can be used in leveraged buyouts organized by management, it follows that they can also be used in buyouts organized by outsiders. These transactions can be "friendly" or "hostile". So long as the ESOP rules are followed, the benefits follow as well.

Now, it has recently occurred to a number of companies that ESOPs can also be useful in defending against hostile takeovers. Perhaps the best known recent example is Phillips Petroleum, which included a large ESOP as part of its recapitalization strategy. This strategy was designed to implement a peace treaty with Mr. Boone Pickens, and to ward off other potential raiders. Ultimately, this strategy failed and was replaced by another, but its highly visible use of an ESOP will not be forgotten.

Indeed, no legal or financial advisor would fail to consider whether an ESOP makes sense when planning a major corporate transaction today. Although my firm is best known for its work with Weirton Steel, we have been involved in a number of transactions involving ESOPs and have served as the independent advisor to ESOPs proposed for a number of companies, such as National Can.

What is the reason for the current popularity of ESOPs in major financial transactions? Of course, the tax advantages are an important consideration. The most important tax provision is the deductibility of principal repayment. Since most major transactions involve publicly held companies, and since few lenders have need of the partial tax exemption, the provisions dealing with close corporations and interest exemptions have had less impact.

Although the deductibility of loan repayments is a significant advantage, it is essentially a neutral element in contested takeovers. While it is somewhat more difficult for a raider to construct an ESOP plan, it is possible for both the hunter and the target to include the benefits of the ESOP in their financial planning.

Moreover, the tax benefits of an ESOP do not come free to the promoters. Ultimately, the stock passes to the employees for whose benefit the ESOP is created. Current rules require that the stock be acquired at no more than its fair value. In some cases, efforts have been made to dilute that value by issuing other forms of securities to the promoters which are subsequently convertible into a larger share of the same equity contributed to the ESOP. Regulation of this practice by the Labor Department and the I.R.S. has been fairly aggressive in recent years and has caused the restructuring of many ESOP plans.

Perhaps the principal benefit of an ESOP in many corporate transactions is not the tax advantage at all. Instead, the ESOP serves as a repository of control. Stock issues to an ESOP can be voted like any other stock. To the extent the vote is passed through to the employees, who are usually management employees, the inclination is to favor the parties who created the ESOP.

Contrast this with the case where the company, using the same borrowing power, buys its own stock from the public. The stock which is bought in is retired and not voted and actually increases the power of minority shareholders. Stock which is bought by an ESOP, on the other hand, remains voting stock and, if it is newly issued, actually dilutes the minority.

Even this power of control, however, is being weakened. Recent efforts of the Labor Department have strengthened the independence of ESOP trustees and their advisors. Like trustees of any other employee benefit plan, these trustees are being held to a fiduciary standard. This standard means they must act in the best interests of their beneficiaries as shareholders rather than as members of management or affiliates of some other group.

This has been a brief summary of a very complicated subject. My experience leads me to draw the following conclusions which may be relevent to your inquiry:

(1) The merits of special tax treatment for ESOPs can be debated, just as the deductibility of charitable contributions can be criticized, but a change in the rules will have a significant impact on the transactions to which they apply. As I said earlier and believe firmly, Weirton Steel would not exist today without the tax benefits available to it as an ESOP.

(2) As a consequence, I would approach any change in the ESOP rules with caution. I believe Weirton to have been an important transaction, not only because it preserved eight thousand jobs, but also because it is designed to modernize and strengthen important industrial capacity which would otherwise be abandoned.

(3) Once tax benefits for a Weirton-type ESOP are established, it is difficult to draw the line at other transactions. An ESOP is like preferred stock or purchase accounting: it makes some transactions more likely and others less so, but there is nothing in the nature of the tax treatment that causes or prevents abuse. If there is abuse, I believe it lies elsewhere—not in the tools available but in the uses to which they are put. A saw and hammer can build a house or tear it down. A good loan builds capital with a future return; a bad loan drains a company of its vitality. Good managers produce profits if they are permitted to do so; bad managers will fail in the long run no matter what circumstances they are given to manage.

(4) If there are abuses specifically connected to ESOPs, I believe they are of two kinds: first, the piling up of corporate debt, which may leave the employee-beneficiaries at risk in a weaker company; and second, the use of an ESOP to acquire control and to take actions which are not in the interests of minority shareholders.

A remedy for the second problem lies outside of the tax code and must be found in the area of securities regulation. Protection for minority shareholders can and should be found in a requirement to obtain the consent of affected minorities. A requirement for consent is particularly important in the case of transactions with affiliates of majority stock holders. Informed consent is the foundation of our present securities laws and should remain so.

As to the first point, the answer again is consent. An ESOP like any other employee trust must be organized and run for its beneficiaries. Should it prove necessary to limit the advantages available to ESOPs, those limits should not prevent the benefits from accruing to those employees who consent to them.

At a minimum, in order to make situations like Weirton possible in the future, any ESOP which is the product of collective bargaining should be entitled to the tax benefits currently enjoyed. By the same token, any ESOP consisting of non-represented employees who give their consent to its establishment should have the same benefits.

I am not an ideologue about ESOPs. I learned about them when they presented a practical solution to a practical problem at Weirton. I am currently engaged in other similar projects whose completion is important to my clients. I believe many of them serve important objectives of public policy, as well, and merit your interest and your support.

Chairman PICKLE. Well, I thank you and thank all of you, gentlemen.

You are all investment bankers or representing investment bankers. When you submit your statement, I wish you would also submit your clients, people that you have worked with in these mergers and acquisitions. It is a matter of record, but we would like to know what companies you are talking about and what was involved.

[Material supplied by Mr. Gleacher, and Mr. Profusek follow:]

MORGAN STANLEY

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April 4, 1985

Ms. Beth Kuntz
Staff Director
Subcommittee on Oversight
Committee on Ways & Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Beth:

Just a short note to thank you for all you did to make the subcommittee's hearing on the tax aspects of mergers and acquisitions such a success. I appreciated the opportunity to participate in this dialogue.

Following your request, I am enclosing:

(1) A list of M&A deals for Morgan Stanley in 1984

(2) The 1984 McKinsey report on mergers and aggregate concentration.

Please let me know if we can provide you with any additional information. We look forward to working with you in the future.

Sincerely,

Eric Gleacher
Managing Director

MORGAN STANLEY & CO.
INCORPORATED
1251 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10020

When complex mergers and acquisitions are accomplished, the name of a particular investment bank stands out.

$52 billion aggregate value of transactions in 1984.

MORGAN STANLEY

	Acquiring Company	Acquired Company	Form of Transaction	Approximate Size
Energy	**Apache Petroleum Company***	Continental U.S. oil and natural gas properties of the Natomas subsidiary of Diamond Shamrock Corporation	Cash Purchase of Assets	$ 160,000,000
	The Broken Hill Proprietary Company, Ltd.	**Utah International Inc. (a subsidiary of General Electric Company)***	Purchase of Assets using Cash and Joint Venture Interest	$ 2,400,000,000
	Cabot Corporation*	Westar Transmission Division of Pioneer Corporation	Purchase of Assets Using Cash and Deferred Payment Obligation	$ 315,000,000
	Chevron Corporation*	Gulf Corporation	Cash Tender Offer and Merger	$13,200,000,000
	Hiram-Walker Resources Ltd.	**Sovereign Oil and Gas PLC (interest held by Dome Petroleum Ltd.)***	Purchase of 22.9% interest	$ 30,600,000
	Houston Natural Gas Corporation*	Transwestern Pipeline Company (a subsidiary of Texas Eastern Corporation)	Cash Purchase of Stock	$ 390,000,000
	Litton Industries, Inc.*	Core Laboratories, Inc.	Cash Tender Offer and Merger	$ 190,000,000
	Group of Japanese Companies including Mitsubishi Group	**Mitsubishi Oil Company, Ltd. (interest held by Texaco Inc.)***	Purchase of 50% interest	$ 335,000,000
	Mobil Corporation	**The Superior Oil Company***	Merger involving Cash and Debentures	$ 5,700,000,000
	Phillips Petroleum Company*	Aminoil Inc. and Geysers Geothermal Company (subsidiaries of R.J. Reynolds Industries, Inc.)	Cash Purchase of Assets	$ 1,700,000,000
	SPNV Holdings, Inc. (a subsidiary of Shell Petroleum N.V.)*†	Minority Interest Shares in Shell Oil Company	Cash Tender Offer for Remaining 30%	$ 5,490,000,000
	Unimar Company (an indirect subsidiary of Allied Corporation and Ultramar PLC)	**ENSTAR Corporation***	Cash Tender Offer followed by Merger involving Cash and Indonesian Participating Certificates in an Indonesian Joint Venture	$ 511,000,000
Real Estate	**Walt Disney Productions***	Arvida Corporation	Common Stock Exchange	$ 200,000,000
	First Winthrop Corporation	**Nineteen New York Commercial Real Estate Properties of the John D. and Catherine T. MacArthur Foundation***	Cash Purchase of Assets	$ 350,000,000
	Pacific Lighting Corporation	**The Presley Companies***	Common Stock Merger	$ 118,000,000

***Morgan Stanley Client**
†Transaction pending

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	Acquiring Company	Acquired Company	Form of Transaction	Approximate Size
Industrial	**Alcan Aluminium Limited***	Aluminum Assets of Atlantic Richfield Company	Cash and Securities for Assets	$ 600,000,000
	American Standard Inc.*	The Trane Company	Cash Purchase of Stock followed by Common Stock Merger	$ 460,000,000
	The Anschutz Corporation	**Rio Grande Industries, Inc.***	Cash Tender Offer and Merger	$ 496,500,000
	Cipher Data Products, Inc.	**Spectra Logic Corporation***	Common Stock Merger	$ 15,000,000
	Consolidated Foods Corporation*	Douwe Egberts	Purchase of 28% minority interest which increased its interest to 93%	$ 100,000,000
	Consolidated Foods Corporation*	Nicholas Kiwi Limited	Cash Purchase of 78% Interest (100% of foreign assets and 14.9% of domestic assets)	$ 317,000,000
	The Dow Chemical Company*	Texize Division of Morton Thiokol, Inc.	Cash and 1.4 million shares of Morton Thiokol	$ 250,000,000
	The Dun & Bradstreet Corporation*	Datastream PLC	Cash Tender Offer and Merger	$ 102,000,000
	First City Properties Inc.	**Scovill Inc.***	Cash Tender Offer and Merger	$ 530,000,000
	Hallmark Cards, Incorporated	**Binney & Smith Inc.***	Cash Merger	$ 207,000,000
	Hasbro Industries, Inc.	**Milton Bradley Company***	Cash Tender Offer and Merger	$ 360,000,000
	Kiewit-Murdock Investment Corporation	**The Continental Group, Inc.***	Cash Merger	$2,787,000,000
	Libbey-Owens-Ford Company*	The Vickers Operations of Sperry Corporation	Purchase of Assets using Cash and Notes	$ 265,000,000
	The Lubrizol Corporation	**Agrigenetics Corporation***	Common Stock Exchange	$ 48,000,000
	McDonnell Douglas Corporation	**Computer Sharing Services, Inc. (a subsidiary of Rio Grande Industries, Inc.)***	Cash Purchase of Stock	$ 69,200,000
	Nippon Kokan K.K.*	International Light Metals Corporation (a subsidiary of Martin Marietta Corporation)	Cash Purchase of 40% of Stock	Not disclosed

*Morgan Stanley Client
†Transaction pending

	Acquiring Company	Acquired Company	Form of Transaction	Approximate Size
Industrial (continued)	**Nippon Kokan K.K.***	National Steel Corporation (a subsidiary of National Intergroup, Inc.)	Purchase of 50% of Stock	$ 292,000,000
	Nisshin Steel Company, Limited*	Wheeling-Pittsburgh Steel Corporation	Minority Interests and Associated Joint Venture	$ 35,000,000
	Norfolk Southern Corporation	**North American Van Lines, Inc. (a subsidiary of PepsiCo., Inc.)*†**	Cash Purchase of Stock	$ 315,000,000
	PMC Holdings, Inc.*	PMC Industries, Inc.	Leveraged Buyout	$ 70,000,000
	The Parsons Corporation Employee Stock Ownership Plan	**The Parsons Corporation and RMP International, Ltd. (interest held by The Ralph M. Parsons Foundation*)**	ESOP Leveraged Buyout	$ 560,000,000
Forest Products	Champion International Corporation	**St. Regis Corporation***	Cash Tender Offer and Merger	$1,900,000,000
	Georgia-Pacific Corporation	**Monticello mill and domestic Container Division of St. Regis Corporation***	Cash Purchase of Assets	$ 343,000,000
	Kruger Inc.*	Bowater Newfoundland Limited (a subsidiary of Bowater, Incorporated)	Cash Purchase of Stock	Not disclosed
Retailing	American Stores Company	**Jewel Companies, Inc.***	Cash Tender Offer and Merger	$1,114,000,000
	General Cinema Corporation	**Carter Hawley Hale Stores, Inc.***	Purchase of 37.6% Minority Interest After Repurchase Program	$ 300,000,000
	Imasco Limited*	Peoples Drug Stores, Incorporated	Cash Tender Offer and Merger	$ 320,000,000
	Imasco Limited* (Peoples Drug Stores, Inc. subsidiary)	Rea and Derick, Inc. (a subsidiary of American Stores Company)	Cash Purchase of Stock	Not disclosed
	Investors Group	**Tiffany & Company (a subsidiary of Avon Products, Inc.)***	Cash Purchase of Stock	$ 135,500,000
	K mart Corporation	**Walden Book Company, Inc. (a subsidiary of Carter Hawley Hale Stores, Inc.)***	Cash Purchase of Stock	$ 295,000,000

***Morgan Stanley Client**
†Transaction pending

	Acquiring Company	Acquired Company	Form of Transaction	Approximate Size
Communi-cations	**American Telephone and Telegraph Company***	Ing. C. Olivetti & C., S.p.A.	Purchase of 25% Minority Interest	$ 260,000,000
	Boston Ventures Limited Partnership	**Billboard Publications, Inc.***	Cash Purchase of Stock	$ 36,000,000
	The Field Corporation*	Pioneer Press Inc. (a subsidiary of Time Incorporated)	Cash Purchase of Stock	Not disclosed
	Price Communications Corporation*	WEEK-TV and KRCG-TV of the LDX Group, Inc. subsidiary of Kansas City Southern Industries, Inc.	Cash and Stock Purchase	$ 31,000,000
	Saatchi & Saatchi Company PLC*	Hay Group, Inc. and Hay Associates	Cash Purchase of Assets	$ 100,000,000
	Venture banking affiliates of E.M. Warburg, Pincus & Co., Inc. and Hallmark Cards, Incorporated	**SFN Companies, Inc.***	Cash and Preferred Stock Purchase	$ 471,392,000
	Mortimer B. Zuckerman	**U.S. News and World Report, Inc.***	Cash Purchase of Stock	$ 168,500,000
Health Care	**Fujisawa Pharmaceutical Co., Ltd.***	LyphoMed Inc.	Cash Purchase of 22.5% of Stock	$ 26,250,000
	The Gillette Company	**Oral-B Laboratories, Inc. (a subsidiary of Cooper Laboratories, Inc.)***	Cash Purchase of Stock	$ 188,500,000
	GrandMet USA, Inc.*	Quality Care, Inc.	Cash Merger	$ 124,000,000
	Eli Lilly and Company*	Advanced Cardiovascular Systems, Inc.	Common Stock Exchange	$ 124,500,000
Financial Services	American Asian Bank	**The Toronto Dominion Bank of California***	Cash Purchase of Assets	Not disclosed
	American Express Company*	Investors Diversified Services, Inc.	Merger Involving Cash, Common Stock and Notes	$ 780,000,000
	AmSouth Bancorporation	**FirstGulf Bancorp*†**	Common Stock Merger with Cash Election	$ 110,000,000
	Bank of Boston Corporation	**Casco-Northern Corporation***	Preferred Stock Merger	$ 55,000,000
	Bank of Boston Corporation	**Colonial Bancorp, Inc.*†**	Preferred Stock Merger	$ 75,000,000
	Bank of Boston Corporation	**RIHT Financial Corporation*†**	Preferred Stock Merger with Cash Election	$ 126,000,000

***Morgan Stanley Client**
†Transaction pending

MORGAN STANLEY

	Acquiring Company	Acquired Company	Form of Transaction	Approximate Size
Financial Services (continued)	**Bank of Montreal***	Harris Bankcorp, Inc.	Cash Merger	$ 547,000,000
	The Chubb Corporation	**Volunteer State Life Insurance Company (a subsidiary of Monumental Corporation)***	Cash Purchase of Stock	$ 80,450,000
	The Equitable Life Assurance Society of the United States*	Donaldson, Lufkin & Jenrette Incorporated	Cash Tender Offer and Merger	$ 433,000,000
	The Fuji Bank, Limited*	Walter E. Heller & Company and Walter E. Heller Overseas Corporation (subsidiaries of Walter E. Heller International Corporation)	Cash Purchase of Stock	$ 425,000,000
	Grupo Financiero Nacional, S.A.	**The Insurance Company of Florida (a subsidiary of St. Regis Corporation)***	Cash Purchase of Stock	Not disclosed
	The Marine Corporation*	Independence Bank Group, Inc.	Cash and Convertible Preferred Stock	$ 50,000,000
	New TC Holding Corporation	**TICOR (a subsidiary of Southern Pacific Company)***	Leveraged Buyout	$ 271,000,000
	The Sanwa Bank, Limited*	Continental Illinois Leasing Corporation	Cash Purchase	Not disclosed
	South Carolina National Corporation*	First Bankshares Corp. of S.C.	Cash and Common Stock Merger	$ 173,000,000
	SunTrust Banks, Inc.†	**Trust Company of Georgia*** and Sun Banks, Inc.	Common Stock Merger	$1,200,000,000
	Tenneco Inc.*	Security Life Insurance Company of Georgia	Cash Merger	$ 52,327,000
	Textron Inc.*	Avco Corporation	Cash Tender Offer and Merger	$1,400,000,000

*Morgan Stanley Client
†Transaction pending

REPLY OF MR. PROFUSEK TO REQUEST OF MR. PICKLE

I am a partner in Jones, Day, Reavis & Pogue. As a national law firm, Jones Day has a very large number of regular clients. For example, the firm is the principal outside counsel to more than 50 of the Fortune 500 industrial corporations. However, as indicated in my written statement, I appeared at the April 2, 1985 hearings solely on my own behalf and not on behalf of Jones Day or any of its clients. Accordingly, I am unable to submit a "list of clients" in the sense in which I believe Mr. Pickle intended the term.

Chairman PICKLE. It seems to me that, by and large, you are saying that in all these acquisitions, in the vast majority of them, they are being brought about not because of tax incentives related to the Tax Code, but just because of the ongoing, normal business operations; and that we should not try to interrupt that and let them alone.

Your experience is that, for the most part, the Tax Code is not being used as an incentive. Is that generally correct?

Mr. GLEACHER. Yes.

Chairman PICKLE. Well, we recognize that this is not an easy problem. Perhaps some of the answer might be in the securities field, not in the code area.

I find it bothersome to me, though, that you are saying that deductibility of interest, stepped-up basis, the net operating losses, the greenmail, or even ESOP's except in certain instances really have no bearing on most of these mergers and acquisitions. You may be correct. I find that hard to believe—that they are not the major factors in this to a certain extent, not in every instance but in some cases more than in others.

Now just look here: I looked at the CRF report on the table. I looked at 1984. Standard Oil bought out Gulf for $13 billion. Texaco bought out Getty for $10 billion. Mobil bought out Superior for $5.7. Dutch Oil bought out Shell. Nestles bought out Carnation. General Motors bought out Electronic Data Systems. Beatrice Food bought out Esmark at 2.5. Here's Phillips Petroleum bought out R.J. Reynolds Industries, the energy operations of it, before all the other happened. That is $45 or $50 billion worth of transactions.

I would go home comfortable tonight and say, "Well, it is just business, business operations. One business buying another out in just normal operation."

But something tells me that there is more to it than that. This concerns us.

I would yield for any comments you want to make, but there is something going on more than meets the eye when you say that greenmail is not a bad thing.

Mr. PROFUSEK. Almost nobody is saying that greenmail is not a bad thing. There are securities law amendments that have been introduced, for example, that deal with that problem. There is a whole raft of bills pending that would amend Federal securities laws and other laws in certain respects to inhibit takeovers.

I guess what I am saying, at least, is I don't think that these tax benefits are a motivation for all the activity. They do affect the pricing. They do affect some band of transactions. I tend to think it is mostly the LBO's and the ESOP buyouts and those things, but it doesn't cause what it is that seems to have everybody focusing on

this subject. That deals on that list of transactions you just read down I don't think were caused by tax benefits.

Now the pricing was probably affected by the tax benefits. Whether or not those transactions were done, I don't think is generally affected.

Mr. PERLMUTTER. If I may, Congressman, as you read over that list, there were a couple names that were familiar because my firm was involved in them—specifically, Beatrice's acquisition of Esmark and General Motors' acquisition of EDS.

Just a word, a one-liner, on complicated transactions. Beatrice's acquisition of Esmark was motivated by the strategic decision to acquire marketing and distribution capability. General Motors acquired EDS to acquire technology that they did not possess in-house. These transactions were done for business reasons, and not tax driven, not tax motivated at all.

Chairman PICKLE. I recognize there are nontax motivations in many of these mergers or acquisitions. They are normally not the hostile ones. They may be the friendly mergers. There is a thin line there.

If we deny deductibility of interest in a hostile, then you do the same thing for the friendly. We don't know whether we help ourselves by trying to approach that.

Mr. KEILIN. Mr. Chairman, if I may, I don't think any of us are saying that there is no impact on these transactions of the tax laws. We wouldn't ask you to take that home with you this evening. They obviously affect how these deals are done and the price and who benefits from them.

I would go perhaps a little further than my colleagues in acknowledging that there have been, and probably still are, some cases where the tax laws are more of a motivating factor. Certainly in the old days you could view a net operating loss or certain depreciation benefits as an asset of a company which you could acquire. Laws have been changed in recent years. It is harder to do that, but it is still possible to seek such tax benefits as assets the way you seek other assets.

I think the point we all agree on—and in one form or another I suspect even the witnesses who took apparently strong views the other way would also acknowledge this—if the tax laws could be made perfectly neutral or have no impact whatsoever, mergers and acquisitions would still take place, and they would take place in some sense more rapidly. I think everyone is agreed that if the tax laws were changed, the price at which many companies changed hands would be reduced.

One of the reasons for mergers in the oil business is that it is easier to buy reserves than to create reserves. Well, if the price of mergers is reduced, it will become even cheaper to buy reserves that somebody else has put together rather than to create your own.

The desire for economic combination, the initiating factor, is almost always some business scheme, some business purpose which you see is producing a stronger company and a better profit. Once you start with that motivation, then you determine, along with your bankers and advisors, how to accomplish it. You obviously take account of the tax laws. You want to pay the least tax as pos-

sible, and you want to get the most benefits possible. These deals don't start there and they don't end there.

Chairman PICKLE. Mr. Flippo?

Mr. FLIPPO. Gentlemen, I think what we are all interested in finding out is, are these some sort of tax games? Is the tax system being gamed in these mergers and acquisitions? Has someone got a computer program that they take a tax profile of a company and then they run everyone else's 10K's through it and say, "Hey, we've got matches here and mergers there."

You see, we have a problem. There is some activity going on out there and we are trying to understand what is motivating that activity, and is that a good thing or a bad thing.

You gentlemen are analysts and you understand these things. You can help us a great deal.

We have heard it said that the stock market has undervalued these companies. Do you have computer programs that help identify undervalued companies? If the Tax Code is not a factor in it, what are the factors that are involved in an undervalued company?

Mr. GLEACHER. Well, one factor can be what the parts of the company are worth, if you wanted to sell some of the parts and keep the remainder. Another factor could be that a company is undervalued and you pay a premium to acquire it, are you nevertheless acquiring it at a good enough price to enable you to increase your earnings per share and, therefore, your market value?

Yes, everybody has computer programs, and we are trying to sort out investment opportunities, just as money managers, the people who manage the billions and the trillions of dollars in this country do when they seek out investment opportunities.

If you are interested, I would like to submit a report that we have that was compiled by McKinsey & Co., the consulting firm, on the effect of industrial concentration in this country over the past few years as a function of the merger activity.

Mr. FLIPPO. I think we would like to have that report.

[The report follows:]

McKinsey & Company, Inc.

1984 Update: Mergers and Aggregate Concentration

SECURITIES INDUSTRY ASSOCIATION

McKinsey & Company, Inc. 1700 PENNSYLVANIA AVENUE, N.W. WASHINGTON, D.C. 20006 TELEPHONE 202-393-6820

December 1984

Securities Industry Association
490 L'Enfant Plaza East, S.W.
Washington, D.C. 20024

Dear Sirs:

With this letter we are submitting our report, 1984 Update: Mergers and Aggregate Concentration. As requested by the Securities Industry Association (SIA), we prepared this report as an update of McKinsey & Company's original work in 1980.

The original work, Mergers and Aggregate Concentration (1965-1978), was initiated by the SIA to examine comprehensively and objectively the nature and impact of large mergers on the U.S. economy. The report on this study was submitted to the SIA and subsequently to the staff of key Congressional committees responsible for potential legislation regarding mergers and scale of U.S. businesses.

The original SIA request to McKinsey & Company was prompted by the debate surrounding large merger activity and possible changes in the laws governing mergers. Since 1980, the level of merger activity, its effects on the economy, and proposed legislation have remained issues for debate among economists and policymakers, and the SIA took the initiative to continue its original research. The additional data was compiled in accordance with the original procedure.

This document presents the results of the most recent work. As with the 1980 study, the overall purpose, as agreed at the outset, was not to arrive at value judgments regarding the effects of mergers but rather to make available to all interested constituencies a comprehensive fund of historical data and objective analysis for discussion and decision making on relevant policy issues.

The main body of the report, preceded by a summary and followed by one appendix outlining the report's methodology and a second appendix with additional data, consists of three chapters:

1 - Large Mergers in the U.S. Economy - examining the level and character of large merger activity from 1965 through 1983 in terms of number, size, frequency, and broad industry sectors involved

2 - Aggregate Concentration in the U.S. Economy - examining the proportion of the total U.S. economy represented by large business units, 1965 to 1982

3 - Impact of Large Mergers on Aggregate Concentration Ratios - examining changes in concentration of large business units in terms of merger influence and all other factors.

It has been our pleasure to work on this issue of continuing importance and relevance. We are available to discuss any questions you may have regarding the study.

Respectfully submitted,

McKinsey & Company, Inc.

1984 UPDATE: MERGERS AND AGGREGATE CONCENTRATION

December 1984

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1984 UPDATE: MERGERS AND AGGREGATE CONCENTRATION

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1984 UPDATE: MERGERS AND AGGREGATE CONCENTRATION

SUMMARY

In the spring of 1984, McKinsey & Company, Inc. was asked to review and update the analysis in McKinsey's 1980 report, Mergers and Aggregate Concentration, conducted for the Securities Industry Association.

In doing so, McKinsey relied on two major data gathering projects carried out by Morgan Stanley & Co. Incorporated. The first included large merger data and large company data through 1982, developed by Morgan Stanley and reviewed and verified by Arthur Young. The second data collection effort, carried out in consultation with McKinsey, expanded the original data in three ways: (1) by adding 1983 large merger data; (2) by converting existing merger data to 1983 constant dollars, which required including 228 additional transactions from 1965 to 1982 to meet the revised threshold dollar amounts; and (3) by adding companies to the initial large company data base, which had been developed exclusively from COMPUSTAT, a service of Standard & Poor's.

Readers of both the original 1980 report and the current study will note that while some trends have remained constant, others have shifted significantly as a result of changes in both the economy and the regulatory environment since 1978. More specifically,

- Aggregate concentration has remained relatively stable from 1978 to 1982, increasing by no more than 2 percentage points in any measure during these years.

- Likewise, the impact of large merger activity on aggregate concentration has continued to be minimal.

- In contrast, merger activity has fluctuated both in terms of number of acquisitions and the sector composition of companies engaging in merger activity. While manufacturing companies were the most active acquirers throughout the 1965 to 1978 period, financial institutions have emerged as the dominant acquirers since 1978. The findings on the level of merger activity among financial institutions are significant and reflect the impact of recent deregulation in the banking and financial services sectors.

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These conclusions are elaborated in the report's three chapters:

1 - Large Mergers in the U.S. Economy

2 - Aggregate Concentration in the U.S. Economy

3 - Impact of Large Mergers on Aggregate Concentration Ratios.

Appendix A details the methodology, including the report's sources and the approach to data collection, and Appendix B provides additional data.

1 - LARGE MERGERS IN THE U.S. ECONOMY

The 1980 McKinsey report provided analyses of completed large merger transactions for 1965 to 1978, defined as mergers with acquired company sales or assets of $100 million or more in 1978 dollars. To provide the most current and comprehensive analysis, this report includes large merger transactions from 1965 to 1983, defined as mergers with acquired company sales or assets of $100 million or more in 1983 dollars.* A total of 1,319 domestic mergers (acquisitions of U.S. companies by U.S. companies) and 125 foreign transactions (acquisitions of U.S. companies by foreign companies) are represented. Analysis of these data reveals that:

Over the 19-year period 1965 to 1983, the proportion of total U.S. corporate assets involved in large mergers did not exceed 1.3 percent in any one year. Cumulatively, the 1,319 large domestic mergers during that period involved a total of 6.9 percent of 1983 U.S. corporate assets - all in 1983 dollars (Exhibit 1).

The years 1965 through 1983 reveal a cyclical pattern of large merger activity, with two brief peak periods, 1967 to 1968 and 1981 to 1982 (Exhibits 2, 3).

The sector mix of large merger activity has been fluid. While financial institutions have replaced manufacturers as the most active acquirers, industries outside finance and manufacturing have maintained a relatively small and stable level of activity (Exhibits 4, 5).

The shift in sector activity is particularly apparent in a comparison of the two peak periods. In 1967 and 1968 manufacturing companies represented 76 percent of all acquisitions with financial institutions executing only 9 percent. In 1981 and 1982 financial institutions dominated large merger activity, with 56 percent of total acquisitions. Similarly, financial institutions' share of total acquired assets increased from 33 percent to 58 percent in the two periods (Exhibit 6).

The dramatic shift from the manufacturing to the financial sector reflects changing economic conditions. In 1967 and 1968 manufacturing companies were diversifying, albeit within the broad category of manufacturing, in part as a result of emerging foreign and domestic pressures on

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* Using the GNP deflator, the amount ranged from $35 million in 1965 to $100 million in 1983.

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traditional U.S. heavy industries, which, in turn, prompted many companies to seek increased stock valuations through acquisitions. By contrast, in 1981 and 1982 financial institutions were rapidly reconsolidating in the wake of record-level interest rates and the dislocation in competitive conditions, resulting from government deregulation of the banking industry. As financial institutions confronted performance variability, price pressure, the proliferation of products and services, and the need for increased capital, mergers and acquisitions represented one form of accommodation to the radically altered economic and regulatory environment.

Both manufacturing and finance companies acquire principally within their respective sectors in terms of number of acquisitions and assets acquired. Companies in "other" industries, including retail, transportation, utilities, construction, and services, more frequently acquire outside their respective sectors (Exhibit 7).

The surge of financial institution activity following deregulation is reflected in a comparison of the years 1965 to 1973 and 1974 to 1983. From the first to the second period the number of acquisitions increased by 255 from 532 to 787; financial institutions accounted for 194 of these 255 acquisitions. Likewise, acquired assets increased by $245 billion from $186 billion to $431 billion; financial institutions accounted for 74 percent of the increase - $181 billion out of the $245 billion (Exhibit 8).*

Continuing the comparison between the two periods to examine the size distribution of acquiring and acquired companies reveals the impact of asset-intensive financial institutions, once again. The number of acquiring companies of $1 billion dollars or more increased from 268 to 549. Financial institutions represented 48 percent of the $1 billion or more companies in the 1974 to 1983 period, compared to 25 percent in the earlier period. Similarly, the number of acquired companies of $600 million or more has increased from 63 to 171, and financial institutions account for 61 percent of these acquisitions in the 1974 to 1983 period, a 29 percent increase from the years 1965 to 1973 (Exhibits 9, 10).

Overall, from 1965 to 1983 the largest number of acquisitions (561) were made by companies in the "$1 billion plus" category, while the largest number of acquired companies (838) were in the "Under $200 million" category (Exhibit 11).

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* This exhibit and subsequent exhibits which compare the 1965 to 1973 and 1974 to 1983 periods parallel the analysis in the original report for the years 1965 to 1971 and 1972 to 1978. While the current version compares 9 years of activity to 10 years of activity, the results are consistent with the overall increase in merger activity between 1981 and 1982 and therefore, the inclusion of an additional year in the second period does not significantly skew the analysis.

Despite the fluctuation in large merger activity, multiple acquisitions by large companies remain a comparative rarity. Of acquiring firms during the 1965 through 1983 period, 69 percent made only one acquisition. Only 7 percent made more than three (Exhibit 12).

Acquisitions of U.S. companies by foreign corporations have grown substantially since 1965. From 1965 to 1973, they represented 3 percent, and from 1974 to 1983, 20 percent of total domestic- and foreign-acquired assets (Exhibit 13).

Comparing the same two periods, U.S. assets acquired by foreign companies increased more than twentyfold; assets acquired in domestic transactions increased by 132 percent (Exhibit 14).

While only one large foreign acquisition occurred from 1965 to 1968, the level of foreign activity has gradually and significantly increased since then, reaching a relatively constant threshold from 1978 to 1982, with a lower level of activity in 1983 (Exhibit 15).

Foreign activity has mirrored domestic activity with respect to both the frequency of acquisitions by individual companies and the pattern of sector activity. More than 88 percent of foreign acquiring companies made only one acquisition; and financial institutions superceded manufacturing companies as the principal target of foreign acquirers (Exhibits 16, 17).

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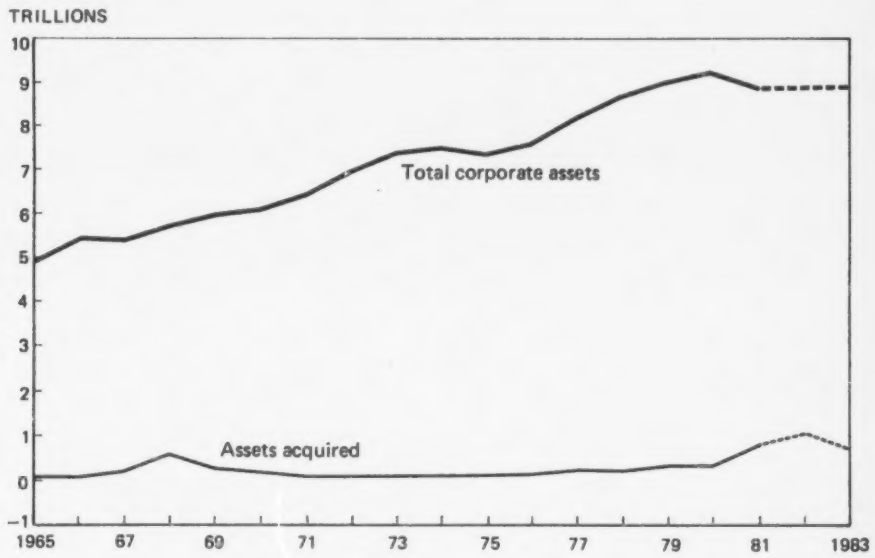
Exhibit 1

TOTAL ASSETS ACQUIRED IN DOMESTIC MERGERS OF $100 MILLION OR MORE COMPARED TO TOTAL U.S. CORPORATE ASSETS, 1965-83*
1983 Dollars



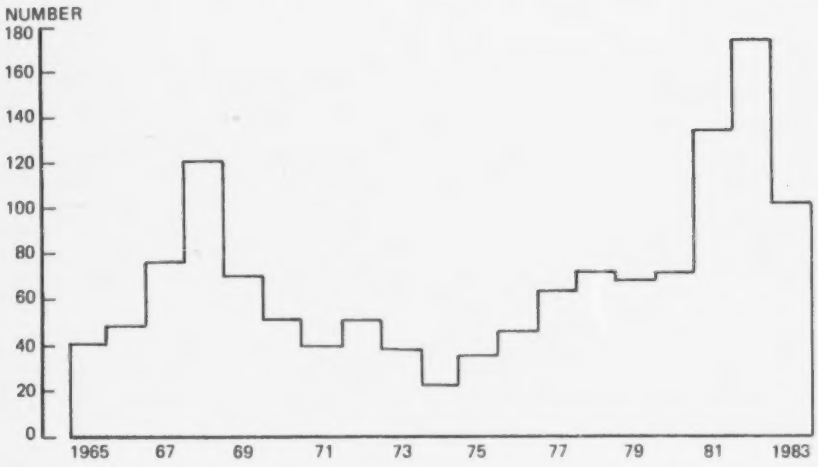
Total Corporate Assets ($ Trillions)	4.9	5.4	5.8	5.7	6.0	6.1	6.4	7.0	7.4	7.5	7.4	7.6	8.2	8.7	9.0	9.2	8.9 (est.)	8.9 (est.)	8.9 (est.)
Assets Acquired ($ Trillions)	.011	.010	.022	.059	.030	.018	.011	.011	.013	.015	.011	.017	.026	.024	.032	.033	.082	.115	.076
% Total	0.2	0.2	0.4	1.0	0.5	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.4	0.4	0.9	1.3	0.9

*Excludes 170 acquired companies for which data were unavailable. All exhibits refer to domestic transactions unless otherwise stated. All exhibits include transactions of $100 million or more in acquired sales or assets in 1983 dollars.

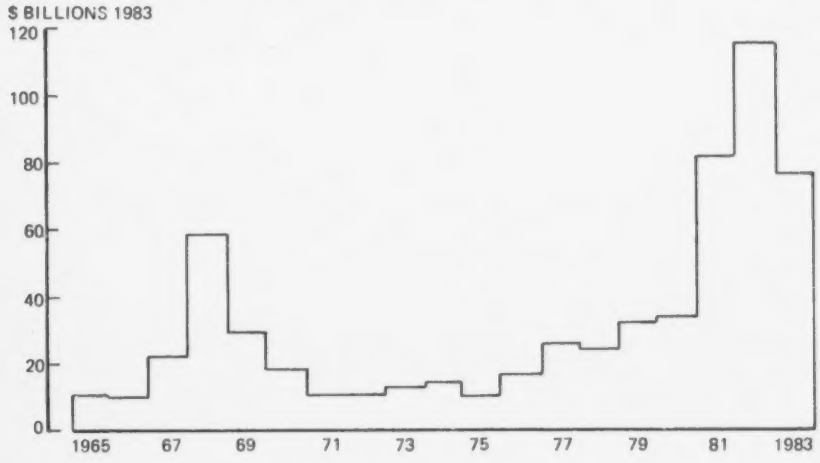
Source: For total corporate assets, IRS, Statistics of Income; 1981-83 data estimated.

Exhibit 2

NUMBER OF LARGE MERGERS
1965-83*



ASSETS ACQUIRED IN LARGE MERGERS
1965-83*



* Defined as sales or assets exceeding $100 million in 1983 dollars.
Excludes 170 acquired companies for which assets data were unavailable.

8

Exhibit 3

MERGER ACTIVITY SUMMARY

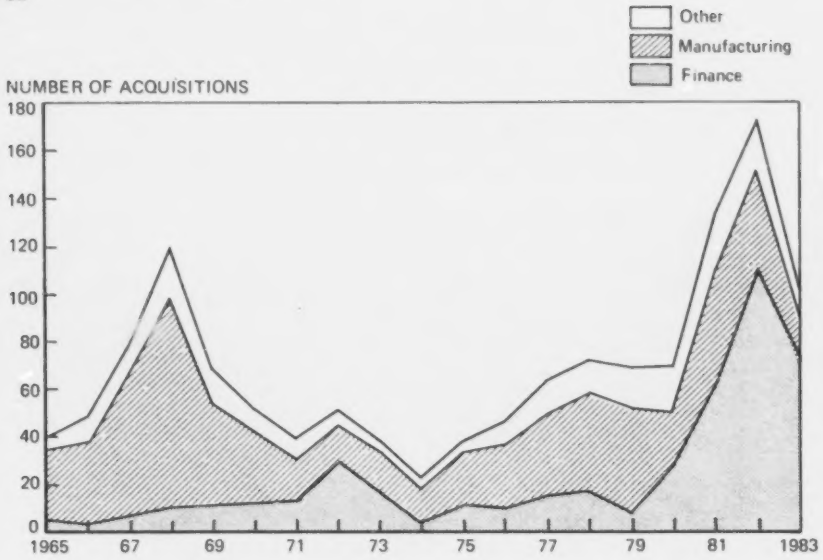
1965-83*

YEAR	NUMBER OF TRANS-ACTIONS	ASSETS ACQUIRED $ Current Millions	ASSETS ACQUIRED $ Millions 1983	MEAN VALUE $ Millions 1983	MEDIAN VALUE $ Millions 1983
1965	40	3,872	11,087	277	169
1966	48	3,652	10,100	210	120
1967	76	8,240	22,073	290	184
1968	120	22,957	59,136	493	151
1969	69	12,085	29,701	431	160
1970	51	7,930	18,476	362	151
1971	39	5,147	11,468	294	173
1972	51	5,177	11,163	219	179
1973	38	6,151	12,559	331	192
1974	22	8,060	15,104	687	165
1975	36	6,228	10,680	297	139
1976	46	10,720	17,477	380	140
1977	63	17,062	26,270	417	214
1978	72	16,501	23,663	329	194
1979	68	24,285	32,060	472	211
1980	71	27,068	32,730	461	218
1981	134	73,913	81,717	610	251
1982	174	110,515	115,215	662	286
1983	101	76,393	76,393	756	231
TOTAL	1,319	$445,956	$617,072	$448	$170

* Excludes 170 acquired companies for which assets data were unavailable.

Exhibit 4

NUMBER OF ACQUISITIONS BY SECTOR
1965-83*



	65	66	67	68	69	70	71	72	73	74	75	76	77	78	79	80	81	82	83
Other	7	10	9	21	15	10	9	7	5	4	3	10	14	15	17	21	24	24	13
Manufacturing	28	35	60	88	43	28	17	15	15	14	21	26	34	40	43	21	49	39	17
Finance	5	3	7	11	11	13	13	29	18	4	12	10	15	17	8	29	61	111	71
TOTAL	40	48	76	120	69	51	39	51	38	22	36	46	63	72	68	71	134	174	101

* Excludes 170 acquired companies for which assets data were unavailable.

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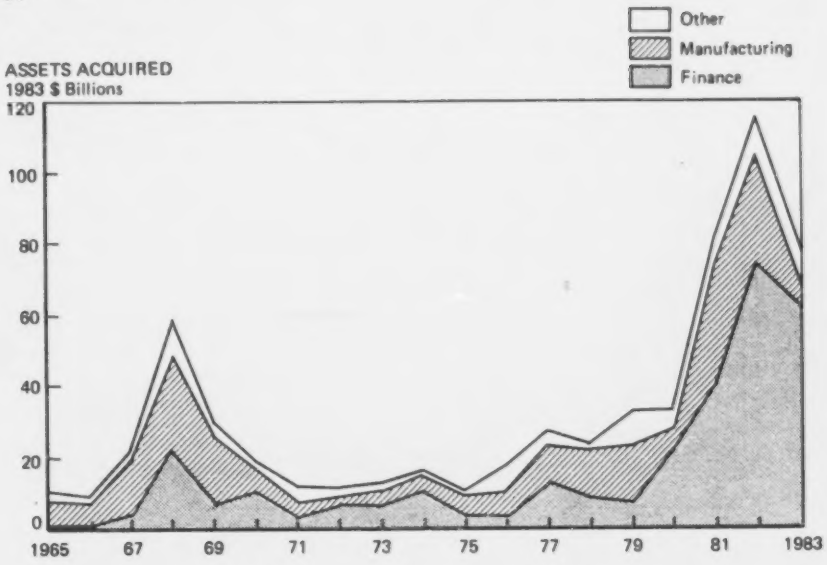
Exhibit 5

ASSETS ACQUIRED BY SECTOR
1965-83*



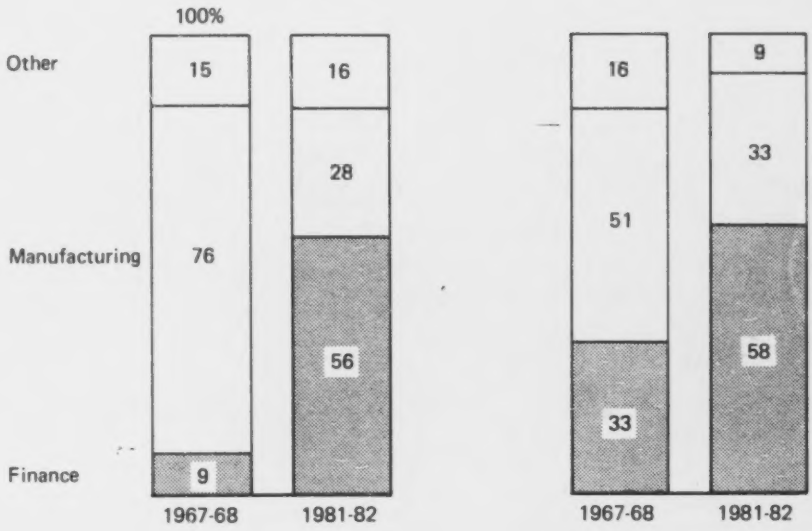
Other	$ 2.4	2.7	2.3	10.9	3.0	1.7	4.1	1.6	2.1	0.8	1.1	6.8	3.2	2.1	8.6	5.6	7.5	10.8	9.7
Manufacturing	$ 7.2	7.0	15.7	25.8	20.7	6.7	4.2	3.1	3.9	3.4	5.8	7.9	10.7	12.9	17.1	5.3	34.0	30.3	5.2
Finance	$ 1.5	0.4	4.1	22.4	6.0	10.1	3.2	6.5	6.6	10.9	3.7	2.8	12.3	8.6	8.4	21.7	40.2	74.1	61.5
TOTAL	$11.1	10.1	22.1	59.1	29.7	18.5	11.5	11.2	12.6	15.1	10.6	17.5	26.2	23.6	32.1	32.6	81.7	115.2	76.4

* Excludes 170 acquired companies for which assets data were unavailable.

11

Exhibit 6

COMPARATIVE SECTOR ACTIVITY
PEAK PERIODS 1967-68; 1981-82

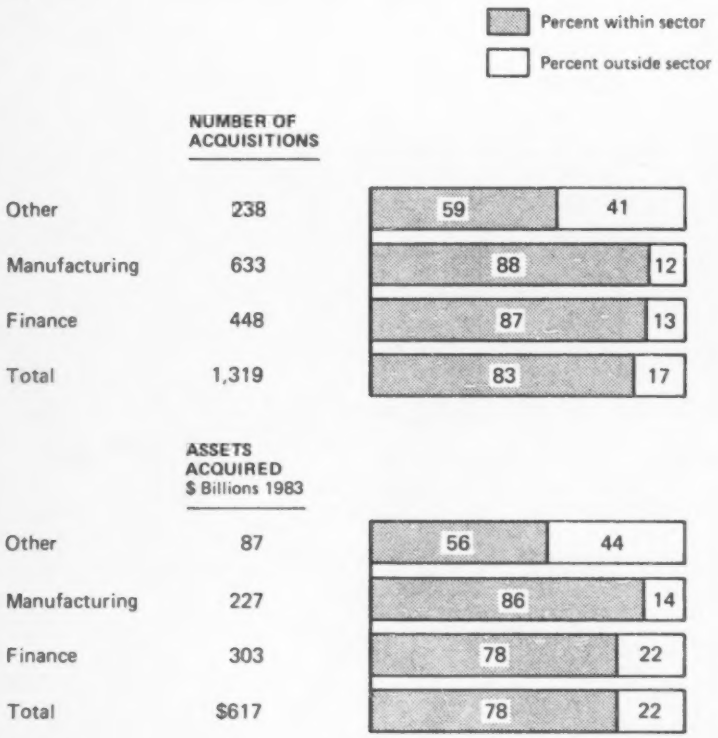


TOTAL NUMBER OF ACQUISITIONS	196	308	**TOTAL ASSETS ACQUIRED** $ Billions 1983	$81.2	$196.9

12

Exhibit 7

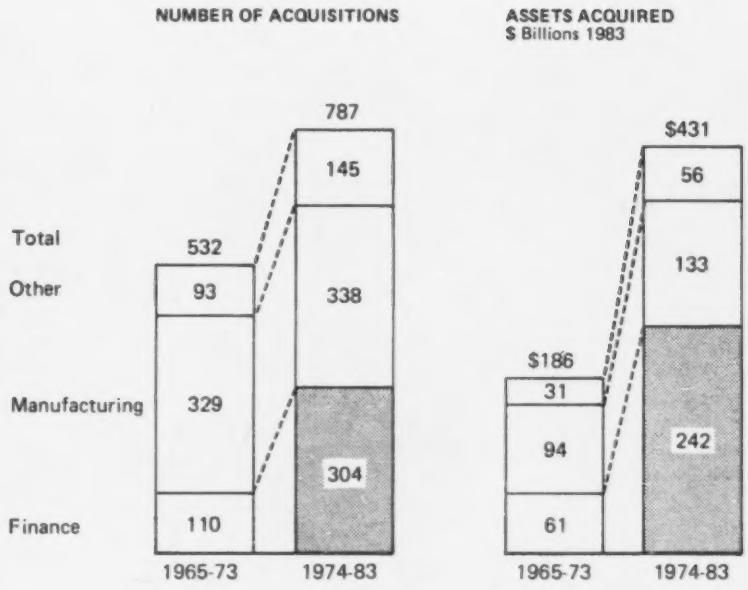
MERGER ACTIVITY WITHIN AND OUTSIDE SECTORS
1965-83*



* Excludes 170 acquired companies for which assets data were unavailable.

Exhibit 8

MERGER ACTIVITY BY SECTOR
1965-83*

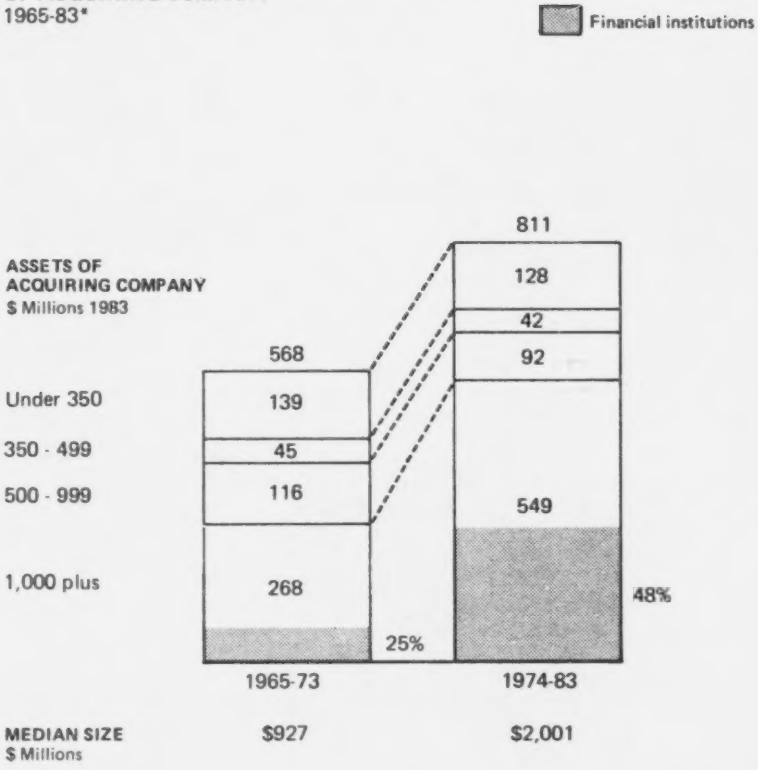


* Excludes 170 acquired companies for which assets data were unavailable.

14

Exhibit 9

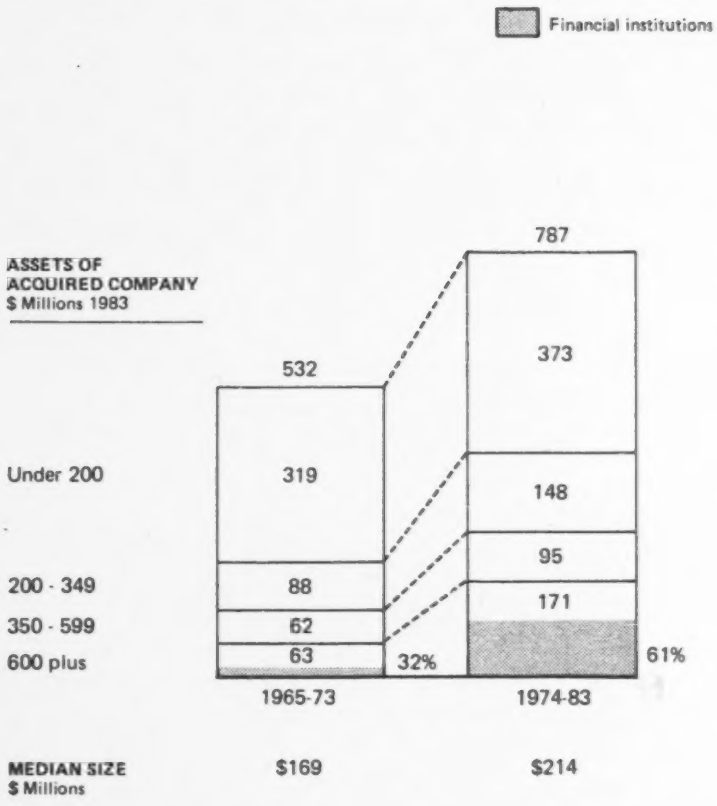
DISTRIBUTION OF ACQUISITIONS BY SIZE OF ACQUIRING COMPANY
1965-83*



* Excludes 110 acquiring companies for which size data were unavailable. Companies making multiple acquisitions are represented more than once in this total. Between 1965 and 1983, 768 individual U.S. companies acquired one or more domestic firms or divisions.

Exhibit 10

DISTRIBUTION OF THE NUMBER OF ACQUISITIONS BY SIZE OF ACQUIRED COMPANY
1965-83*



* Excludes 170 acquired companies for which size data were unavailable.

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Exhibit 11

SIZE GROUPS OF MERGERS BY NUMBER OF TRANSACTIONS AND ASSETS SIZE, 1965-83*
$ Millions 1983

ACQUIRING COMPANY SIZE	ACQUIRED COMPANY SIZE				
	Under 200	200 - 349	350 - 599	600 plus	Total
Under 350	336 $49,327	21 $9,658	10 $7,842	4 $6,968	371 $73,795
350 - 499	72 $12,616	7 $3,223	12 $8,147	5 $17,627	96 $41,613
500 - 999	151 $25,997	30 $13,206	14 $11,426	12 $21,143	207 $71,772
1000 plus	279 $44,638	90 $35,052	67 $38,758	125 $273,378	561 $391,826
Total	838 $132,578	148 $61,139	103 $66,173	146 $319,116	1,235 $579,006

* Excludes 170 acquired companies and 110 acquiring companies for which assets data were unavailable, including 26 transactions for which neither acquired nor acquiring company data were available.

Exhibit 12

MERGER FREQUENCY BY NUMBER OF ACQUISITIONS 1965-83*

ACQUISITIONS PER ACQUIRING FIRM	NUMBER OF ACQUIRING FIRMS	NUMBER OF ACQUISITIONS FROM		
		1965-73	1974-83	1965-83
1	533	208	325	533
2	121	87	155	242
3	59	80	97	177
4	24	38	58	96
5	18	54	36	90
6	6	19	17	36
7	2	8	6	14
8	3	10	14	24
9	0	0	0	0
10	0	0	0	0
11	1	10	1	11
12	1	7	5	12
Total	768	521	714	1,235

* Excludes 170 acquired companies and 110 acquiring companies for which assets data were unavailable, including 26 transactions for which neither acquired nor acquiring company data were unavailable.

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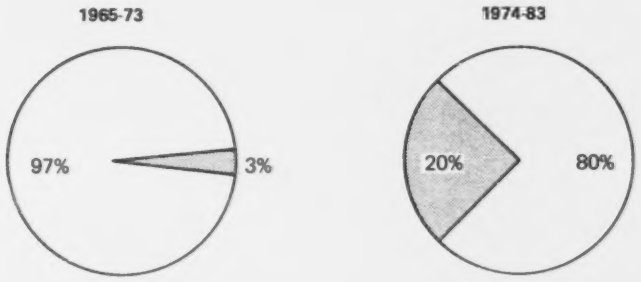
Exhibit 13

FOREIGN SHARE OF TOTAL ASSETS ACQUIRED

1965-83*

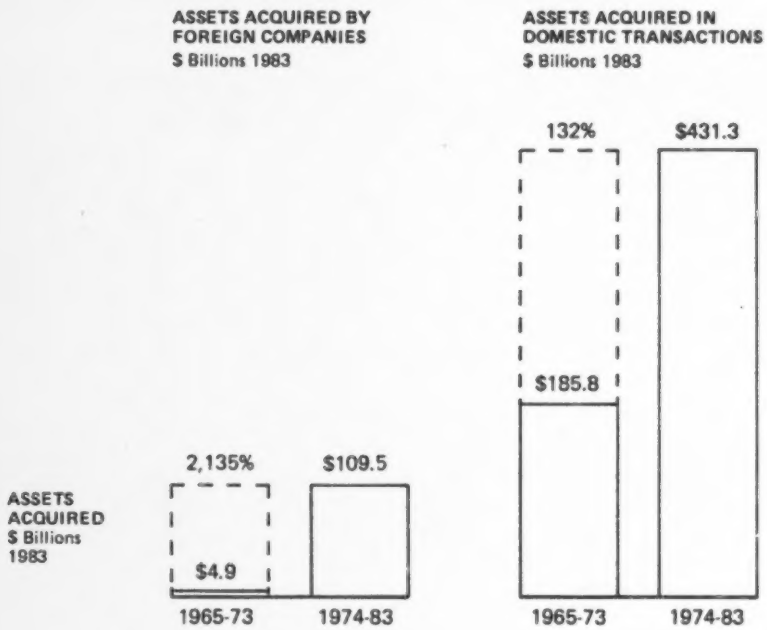


$ Billions 1983		$ Billions 1983
4.9	Foreign	109.5
185.8	U.S.	431.3
190.7	Total	540.8

* Excludes 18 acquired companies for which assets data were unavailable.

Exhibit 14

COMPARISON OF ASSETS ACQUIRED BY FOREIGN COMPANIES AND ASSETS ACQUIRED IN DOMESTIC TRANSACTIONS
1965-83*



	1965-73	1974-83	1965-73	1974-83
NUMBER OF ACQUISITIONS	13	112	532	787

* Excludes 18 foreign acquired companies and 170 domestic acquired companies for which assets data were unavailable.

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Exhibit 15

SUMMARY OF ACQUISITIONS BY FOREIGN COMPANIES
1965-83*

YEAR	NUMBER OF ACQUISITIONS			ASSETS ACQUIRED, $ MILLIONS 1983		
	BY FOREIGN COMPANIES	BY ALL COMPANIES	FOREIGN (%)	BY FOREIGN COMPANIES	BY ALL COMPANIES	FOREIGN (%)
1965	0	40	0	0	11,087	0
1966	0	48	0	0	10,100	0
1967	1	77	1	110	22,183	0.5
1968	0	120	0	0	59,136	0
1969	4	73	5	907	30,808	3
1970	3	54	6	1,426	19,902	7
1971	2	41	5	1,046	12,514	8
1972	1	52	2	172	11,335	2
1973	2	40	5	1,219	13,778	9
1974	8	30	27	13,720	28,824	48
1975	7	43	16	3,154	13,834	23
1976	3	49	6	1,005	18,482	5
1977	8	71	11	1,707	27,977	6
1978	15	87	17	4,375	28,038	16
1979	16	84	19	18,412	50,472	36
1980	21	92	23	25,643	58,373	44
1981	13	147	9	27,578	109,295	25
1982	17	191	9	12,724	127,939	10
1983	4	105	4	1,181	77,574	2
TOTAL	125	1,444	9%	$114,379	$731,451	16%

* Excludes 18 foreign acquired companies and 170 domestic acquired companies for which assets data were unavailable.

Exhibit 16

FOREIGN MERGER FREQUENCY BY NUMBER OF ACQUISITIONS 1965-83*

ACQUISITIONS PER ACQUIRING FIRM	NUMBER OF ACQUIRING FIRMS	NUMBER OF ACQUISITIONS FROM		
		1965-73	1974-83	1965-83
1	69	9	60	69
2	8	2	14	16
3	1	1	2	3
Total	78	12	76	88

* Excludes 18 foreign acquired companies and 44 foreign acquiring companies for which assets data were unavailable, including 7 transactions for which neither acquired nor acquiring company data were available.

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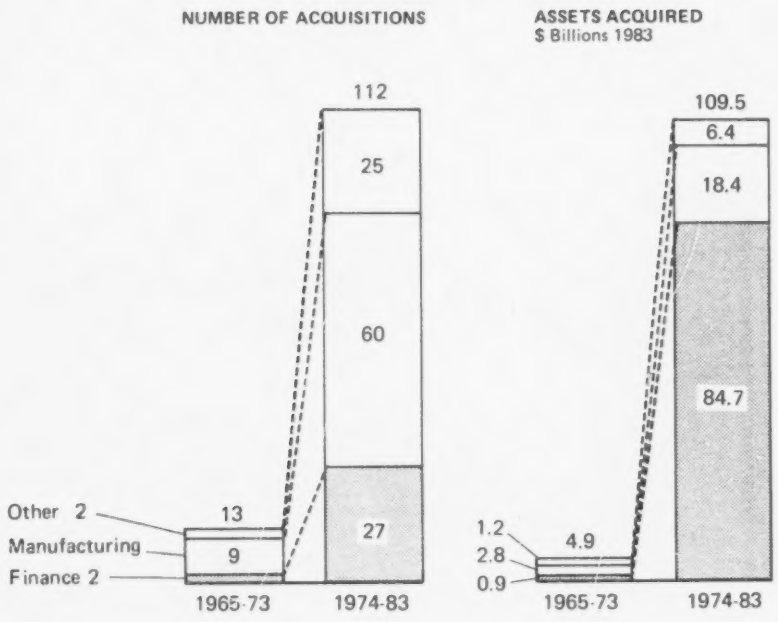
Exhibit 17

FOREIGN MERGER ACTIVITY BY SECTOR
1965-83*



* Excludes 18 foreign acquisitions for which assets data were unavailable.

2 - AGGREGATE CONCENTRATION IN THE U.S. ECONOMY

The 1980 report provided extensive background on the origins and limitations of the aggregate concentration concept, reviewing: (1) the development of the aggregate concentration ratio, dating back to Gardiner Means' work in 1933 and continuing with Betty Bock, J. Fred Weston, Yale Brozen, and other contemporary scholars; (2) the ambiguity of sector definitions, given the increasing diversification of U.S. corporations; (3) inherent overstatements in the ratios as a result of the exclusion of imports and the inclusion of substantial foreign sales and overseas assets; and (4) the fact that aggregate changes do not reveal component changes among companies and industries within each ranked group, resulting from business and economic variables. Together, these methodological and analytical evaluations led us to conclude that "aggregate concentration is a questionable measure of economic activity." We reiterate that conclusion, based on our earlier analysis, while presenting the following data. Exhibits 18 to 24 include sales and assets ratios in 8 base years from 1967 to 1982 for the largest 500 companies in all sectors, the largest 200 nonfinancial companies, the largest 200 manufacturers, and the largest 200 financial institutions.

The sales ratio of the largest 500 U.S. companies, calculated as a proportion of total U.S. sales, measured 34.1 in 1967 and 1982 and fluctuated less than 1 percentage point throughout the 1967 to 1982 period. The assets ratio, reflecting increases in the finance sector, has increased by 4.4 percentage points (Exhibit 18).

The aggregate concentration ratios of the largest 200 U.S. nonfinancial companies to total U.S. sales and assets have remained stable during the 1967 to 1982 period. Both the sales and assets ratios have declined slightly - by 0.8 in sales and by 0.2 in assets (Exhibit 19).

The ratio of the largest 200 U.S. manufacturers to total U.S. sales and assets has also remained stable from 1967 to 1982. The sales ratio has fluctuated no more than 1 percentage point during the entire period, and the assets ratio has measured 12.6 both in 1967 and 1982, with fluctuations of less than 1 percentage point in the intervening years (Exhibit 20).

Aggregate concentration for the largest 200 U.S. financial institutions as a proportion of total U.S. sales and assets has increased slightly from 1967 to 1982 - by percentage points of 1.7 in sales and 4.3 in assets (Exhibit 21).

Sales and assets of the largest 200 U.S. nonfinancial companies as a proportion of total U.S. nonfinancial sales and assets have decreased slightly from 1967 to 1982. Sales have declined from 27.2 to 26.7 percent; assets from 39.3 to 37.4 percent (Exhibit 22).

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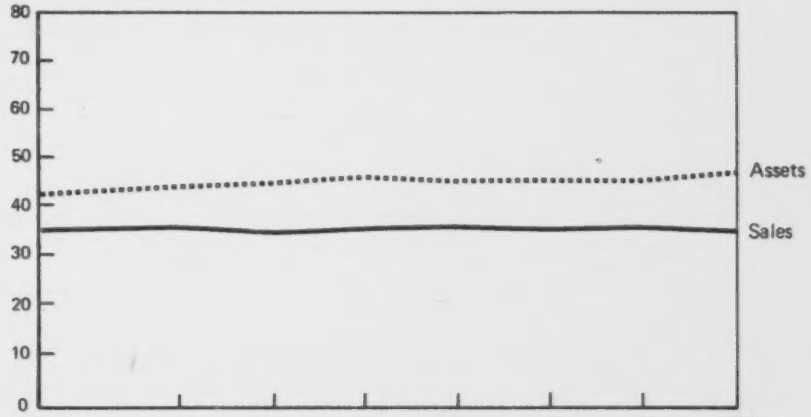
The ratio of the largest 200 U.S. manufacturers to total U.S. manufacturing sales and assets has increased 5.0 percentage points in sales and remained relatively stable in assets, measuring 56.6 percent in 1967 and 56.3 percent in 1982 with fluctuations up to 59.2 percent in the intervening years (Exhibit 23).

The aggregate concentration ratios for the largest 200 U.S. financial institutions as a percentage of total U.S. financial sales and assets have increased. The sales ratio has increased by 4.7 percentage points,; the assets ratio by 8.2 percentage points (Exhibit 24).

Exhibit 18

LARGEST 500 COMPANIES

Percent of total U.S. corporate sales, assets, 1967-82

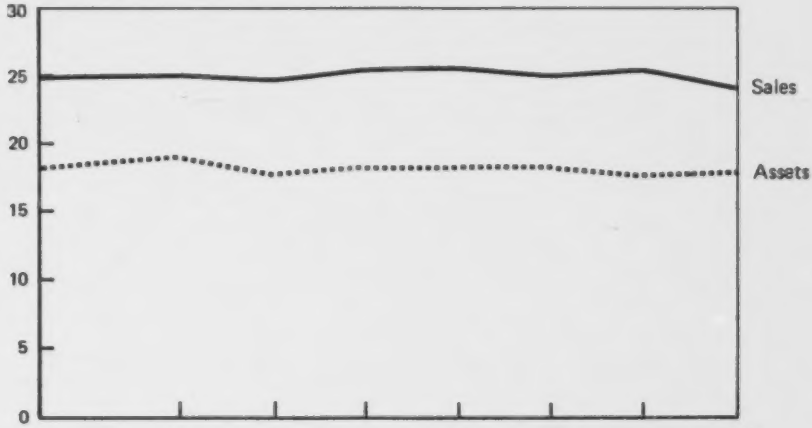


	1967	70	72	74	76	78	80	1982
Assets	41.7	43.5	44.1	45.3	44.9	44.9	44.7	46.1
Sales	34.1	34.5	34.1	34.8	35.0	34.5	34.7	34.1

Exhibit 19

LARGEST 200 NONFINANCIAL COMPANIES

Percent of total U.S. corporate sales, assets, 1967-82



	1967	70	72	74	76	78	80	1982
Sales	24.6	24.8	24.4	25.1	25.3	24.8	25.2	23.8
Assets	17.8	18.6	17.4	17.9	17.9	17.8	17.5	17.6

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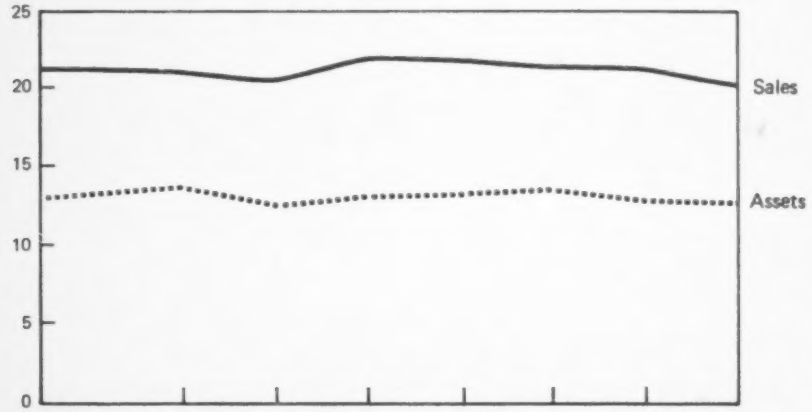
Exhibit 20

LARGEST 200 MANUFACTURERS

Percent of total U.S. corporate sales, assets, 1967-82

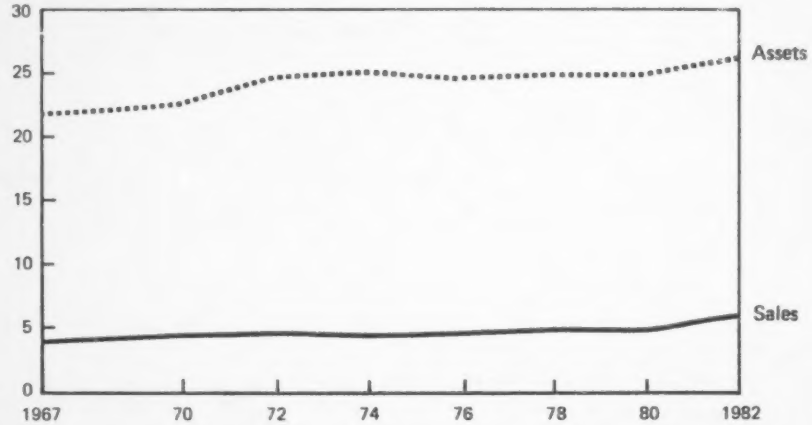


	1967	70	72	74	76	78	80	1982
Sales	20.6	20.8	20.5	21.7	21.8	21.2	21.4	20.0
Assets	12.6	13.4	12.3	12.9	12.9	13.1	12.8	12.6

Exhibit 21

LARGEST 200 FINANCIAL INSTITUTIONS

Percent of total U.S. corporate sales, assets, 1967-82

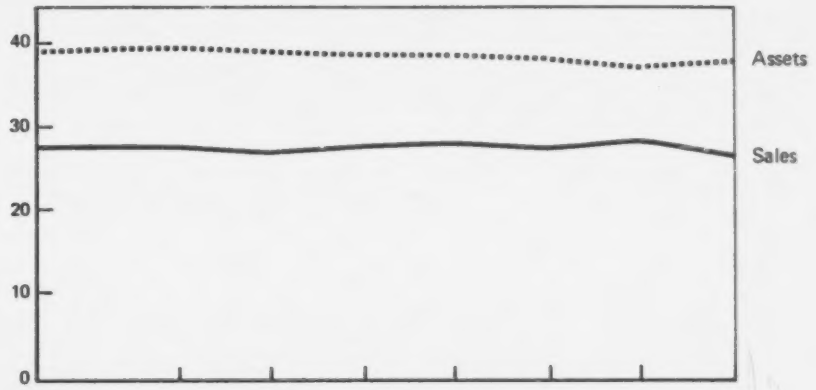


	1967	70	72	74	76	78	80	1982
Assets	21.6	22.5	24.2	24.8	24.4	24.6	24.6	25.9
Sales	3.7	4.0	4.2	4.2	4.2	4.3	4.4	5.4

Exhibit 22

LARGEST 200 NONFINANCIAL COMPANIES

Percent of total U.S. nonfinancial sales, assets, 1967-82

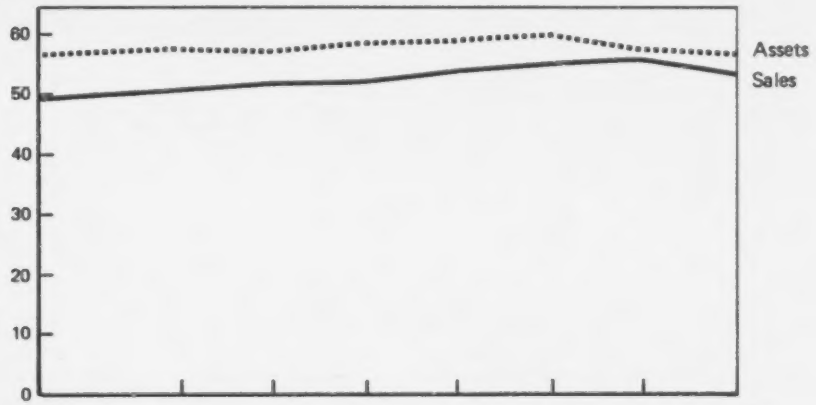


	1967	70	72	74	76	78	80	1982
Assets	39.3	39.6	39.3	39.2	39.0	38.5	37.2	37.4
Sales	27.2	27.6	27.2	27.8	28.0	27.6	28.3	26.7

Exhibit 23

LARGEST 200 MANUFACTURERS

Percent of total U.S. manufacturing sales, assets, 1967-82



	1967	70	72	74	76	78	80	1982
Assets	56.6	57.6	57.5	58.6	58.9	59.2	57.2	56.3
Sales	48.0	50.5	51.1	51.7	53.7	54.5	56.6	53.0

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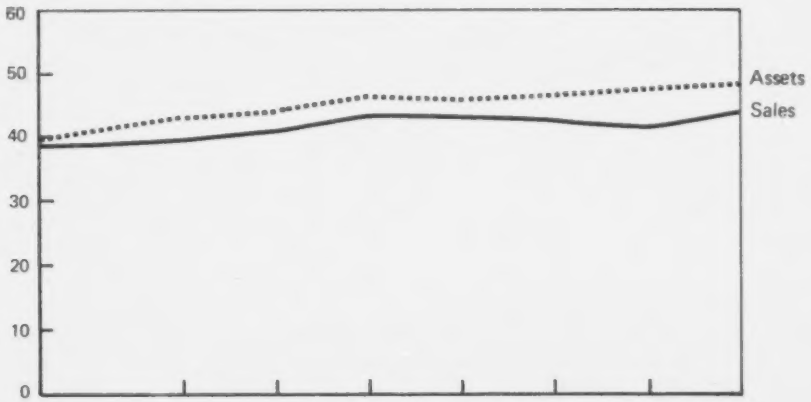
Exhibit 24

LARGEST 200 FINANCIAL INSTITUTIONS

Percent of total U.S. financial sales, assets, 1967-82



	1967	70	72	74	76	78	80	1982
Assets	39.6	42.3	43.5	45.7	45.1	45.7	46.5	47.8
Sales	38.3	39.3	40.4	42.9	42.7	42.3	40.0	43.0

3 - IMPACT OF LARGE MERGERS ON AGGREGATE CONCENTRATION RATIOS

This section presents data on the impact of large merger activity on aggregate concentration for the period 1967 to 1982. As in the original report, four growth scenarios are presented for each company grouping, calculating the effect on aggregate concentration ratios if: (1) the acquired companies with sales or assets of $100 million or more (in 1983 dollars) had not grown at all; (2) they had grown at the 1967 to 1982 rate of inflation, 6.9 percent; (3) they had grown at the 1967 to 1982 GNP growth rate, 9.8 percent; and (4) they had grown at the 1967 to 1982 rate for the ranked companies in their respective sector, e.g., 12.4 percent for the largest 500 companies in sales.

The analysis reveals that without exception in each company grouping internal growth (total growth less merger-related growth) had a far greater impact both on increases in assets and sales and on changes in aggregate concentration than did merger-related growth.

To illustrate, using the four growth assumptions, Exhibit 25 compares the effects of mergers and internal growth on the largest 500 companies changes in sales and changes in aggregate concentration from 1967 to 1982. The exhibit provides the 1967 to 1982 dollar values and the accompanying aggregate concentration ratios that result from the calculations. Using the no-growth assumption, 1982 sales would have been $2,235.4 billion; under the inflation assumption, $2,166.9 billion; under the GNP assumption, $2,122.7 billion; and under the sector assumption (12.4 percent) $2,070.6 billion. Thus, even under the highest growth assumption (sector growth), 82 percent of 1967 to 1982 growth is internally generated and 18 percent is attributable to mergers. That is, of the overall $1,949.7 billion difference between 1967 and 1982 sales, $347.4 billion ($2,418.0 billion less $2,070.6 billion) is the result of mergers and the remaining $1,602.3 billion is the result of internal growth.

Calculating the level of 1982 concentration "without mergers" produced the following results: (1) under the no-growth assumption concentration would have been 31.5 percent; (2) under the inflation assumption it would have been 30.6 percent; (3) under the GNP assumption it would have been 29.9 percent; and (4) under the sector assumption it would have been 29.2 percent. Exhibits 26 through 38 show similar findings for the largest 500

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companies in assets, the largest 200 nonfinancial companies in sales and assets, the largest 200 manufacturers in sales and assets, and the largest 200 financial institutions in sales and assets.*

The analysis of financial institutions merits specific discussion. As Chapter 1 stated, the level of merger activity among financial institutions has increased dramatically since 1980. Despite the recent level of activity resulting from deregulation, the impact of mergers on the overall increase in concentration has been minimal. As Exhibit 38 indicates, under the highest growth assumption (sector growth of 12.62 percent), 94 percent of financial assets have been internally generated and 6 percent are merger-related. Likewise, once again under the sector growth assumption, mergers account for only 2.3 percentage points (47.8 - 45.5) of total 1982 financial assets concentration.

In summary, mergers have had some impact on aggregate concentration, but internal growth has had a substantially greater impact.

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* The respective sector growth rates, expressed in percents, for each ranked group are: 500 companies - sales 12.44, assets 11.98; 200 nonfinancial companies - sales 12.18, assets 11.08; 200 manufacturers - sales 12.18, assets 11.17; 200 financial institutions - sales 15.56, assets 12.62.

Exhibit 25

EFFECTS OF MERGERS AND INTERNAL GROWTH ON CHANGES IN AGGREGATE CONCENTRATION, 1967-82

Largest 500 Companies/Sales

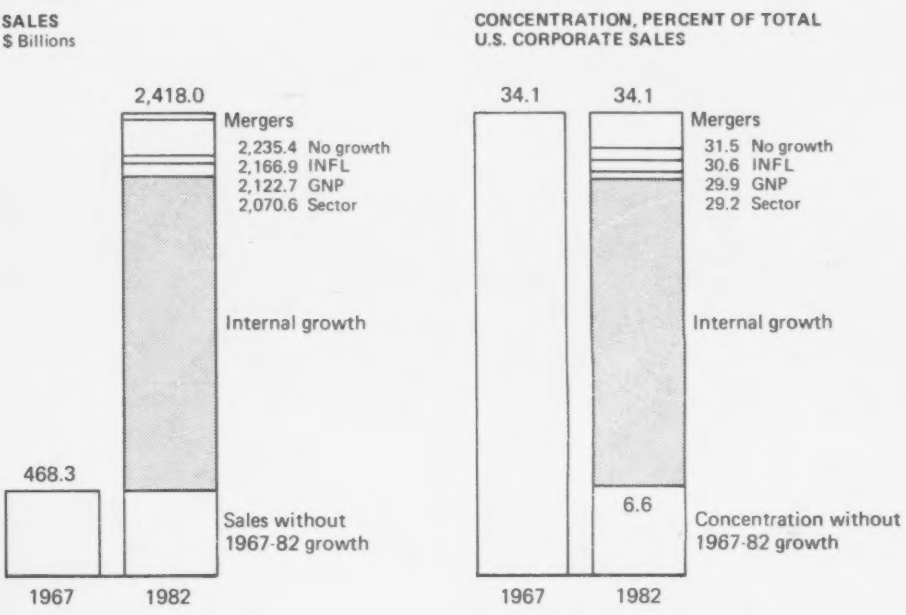

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Exhibit 26

EFFECTS OF MERGERS AND INTERNAL GROWTH ON CHANGES IN AGGREGATE CONCENTRATION, 1967-82

Largest 500 Companies/Assets

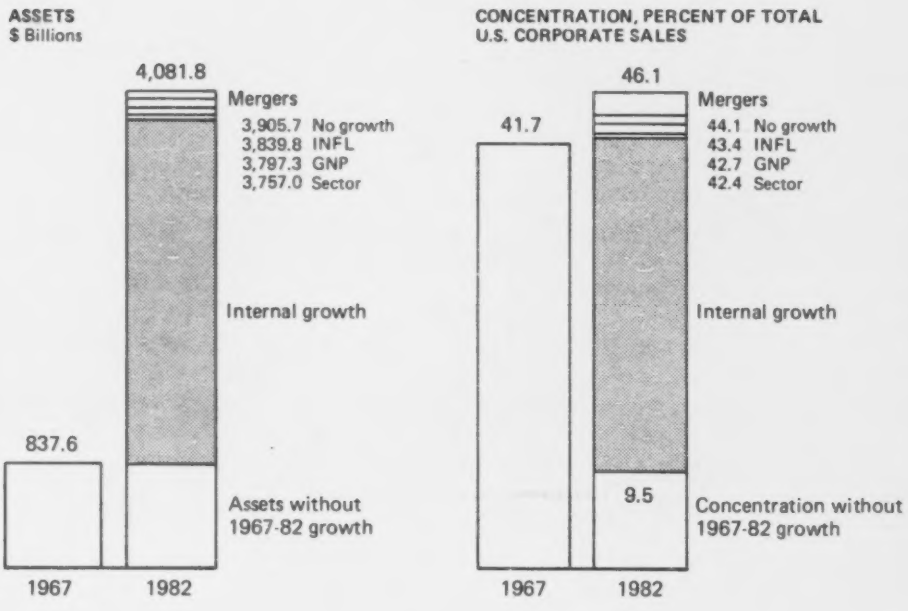

Exhibit 27

EFFECTS OF MERGERS AND INTERNAL GROWTH ON CHANGES IN AGGREGATE CONCENTRATION, 1967-82

Largest 200 Nonfinancial Companies/Sales

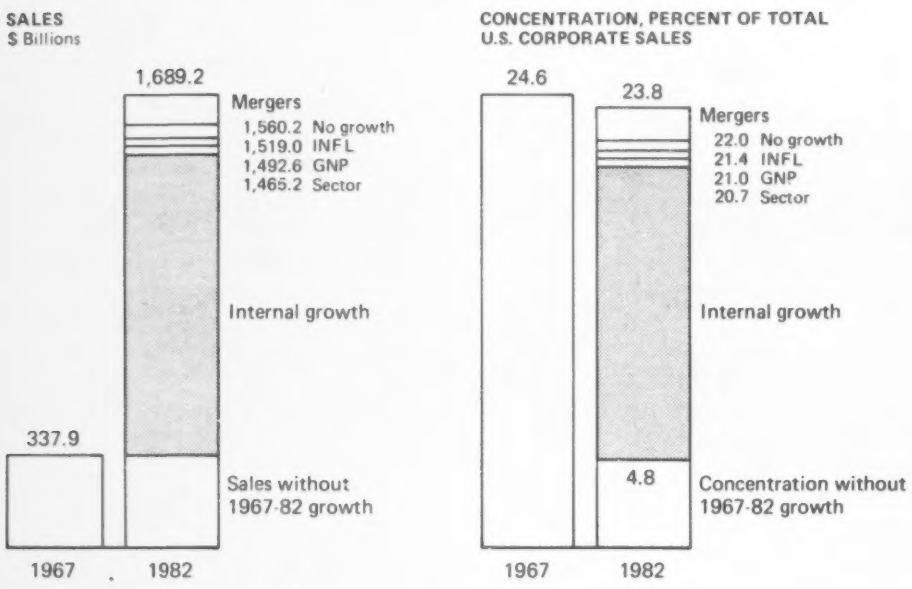

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Exhibit 28

EFFECTS OF MERGERS AND INTERNAL GROWTH ON CHANGES IN AGGREGATE CONCENTRATION, 1967-82

Largest 200 Nonfinancial Companies/Assets

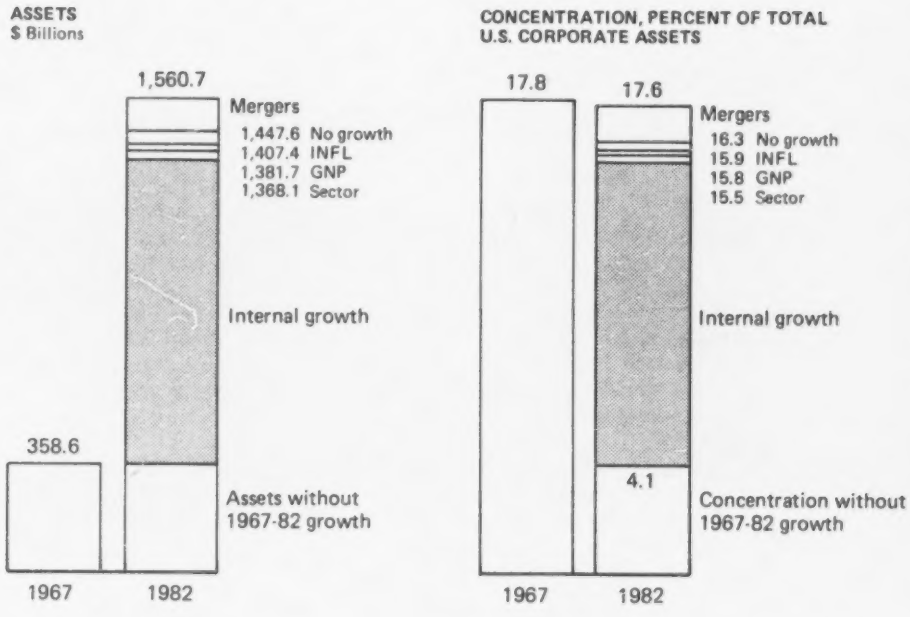

Exhibit 29

EFFECTS OF MERGERS AND INTERNAL GROWTH ON CHANGES IN AGGREGATE CONCENTRATION, 1967-82

Largest 200 Manufacturers/Sales

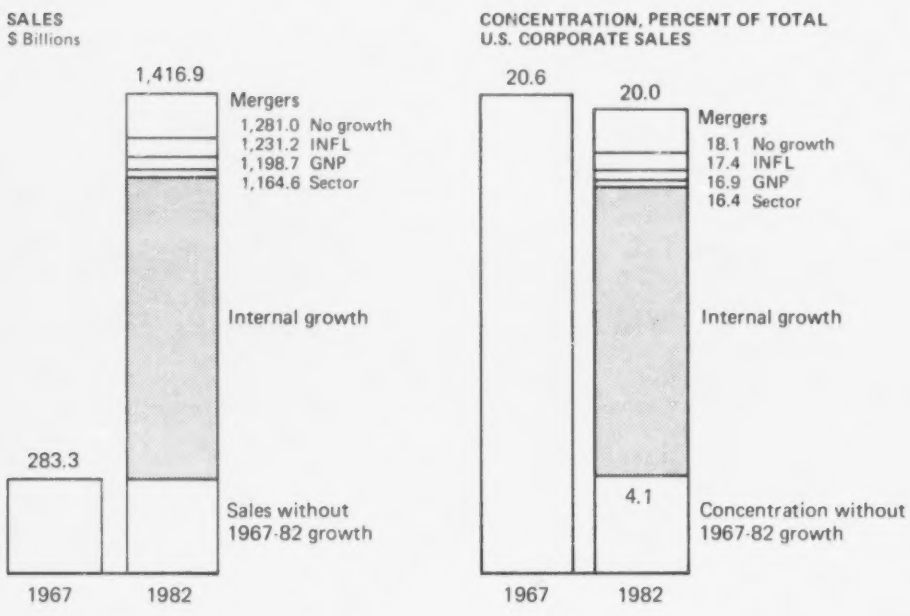

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Exhibit 30

EFFECTS OF MERGERS AND INTERNAL GROWTH ON CHANGES IN AGGREGATE CONCENTRATION, 1967-82

Largest 200 Manufacturers/Assets

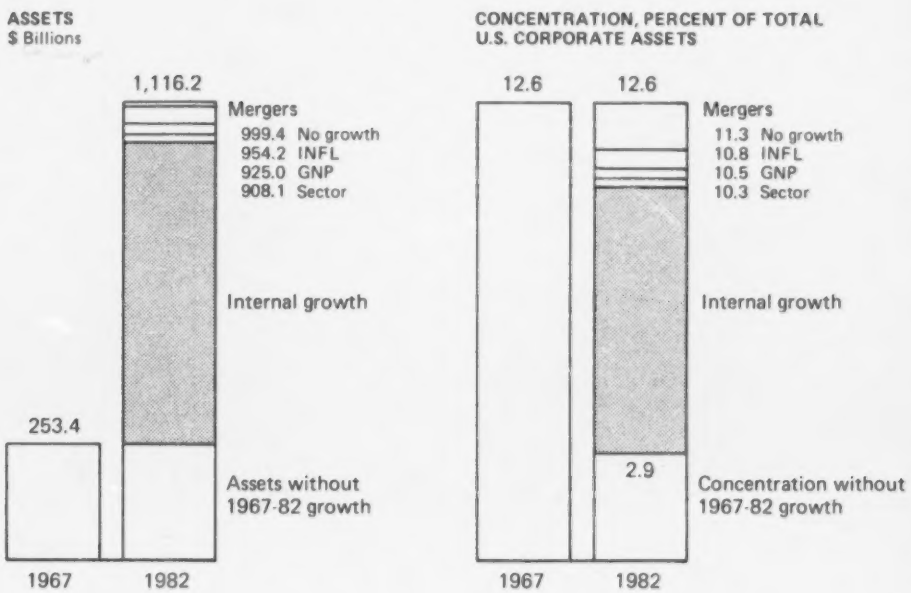

Exhibit 31

EFFECTS OF MERGERS AND INTERNAL GROWTH ON CHANGES IN AGGREGATE CONCENTRATION, 1967-82

Largest 200 Financial Institutions/Sales

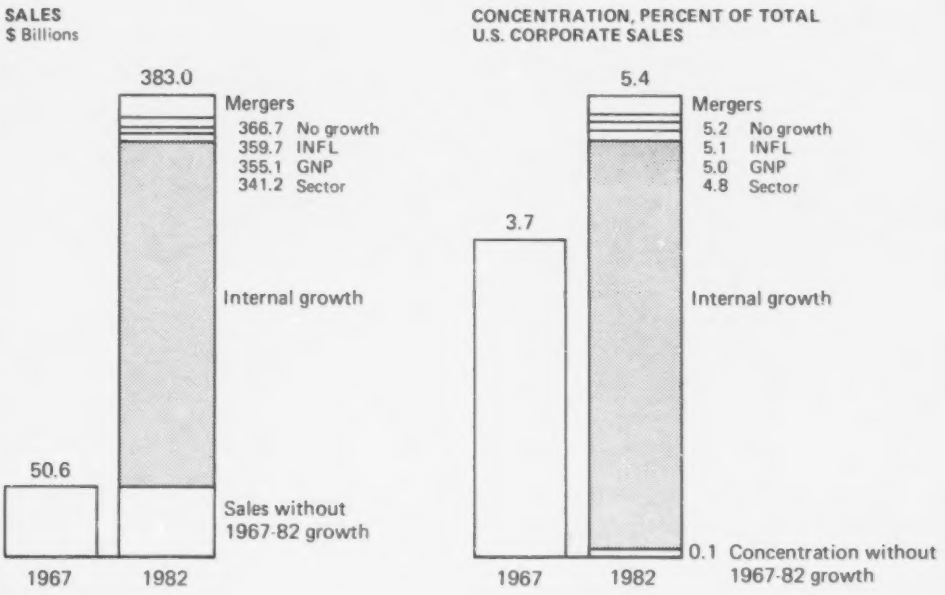

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Exhibit 32
EFFECTS OF MERGERS AND INTERNAL GROWTH ON CHANGES IN AGGREGATE CONCENTRATION, 1967-82
Largest 200 Financial Institutions/Assets

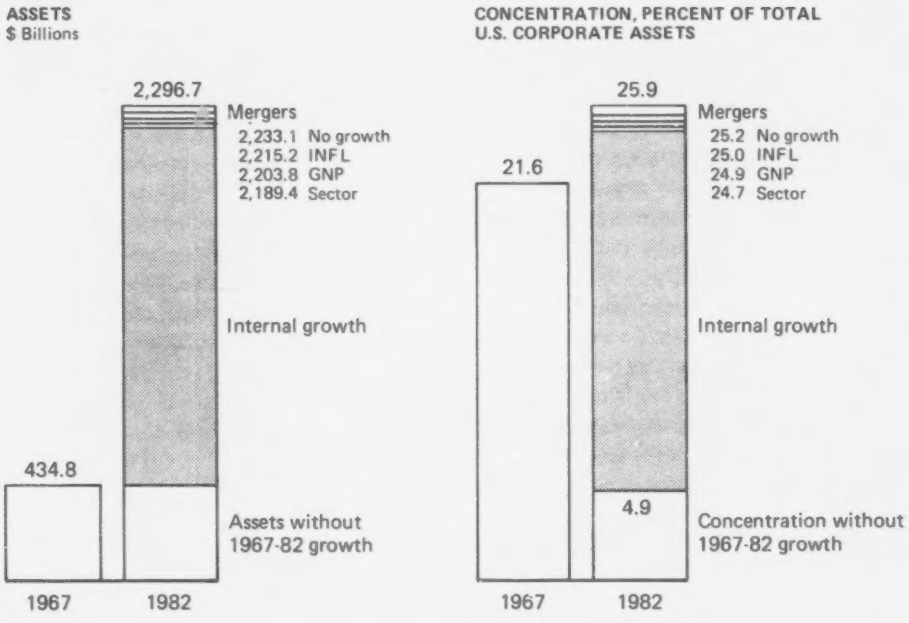

Exhibit 33

EFFECTS OF MERGERS AND INTERNAL GROWTH ON CHANGES IN AGGREGATE CONCENTRATION, 1967-82

Largest 200 Nonfinancial Companies/Sales

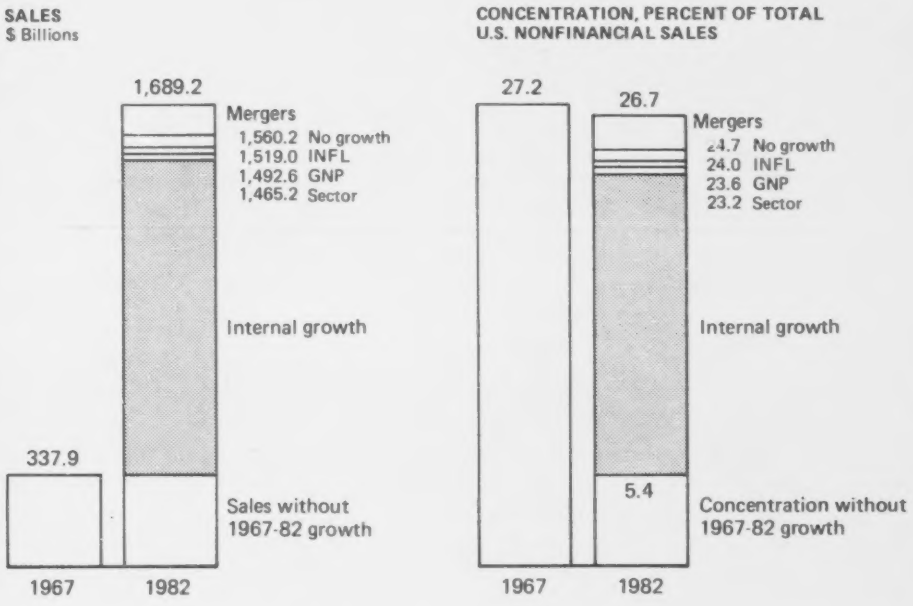

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Exhibit 34
EFFECTS OF MERGERS AND INTERNAL GROWTH ON CHANGES IN AGGREGATE CONCENTRATION, 1967-82
Largest 200 Nonfinancial Companies/Assets

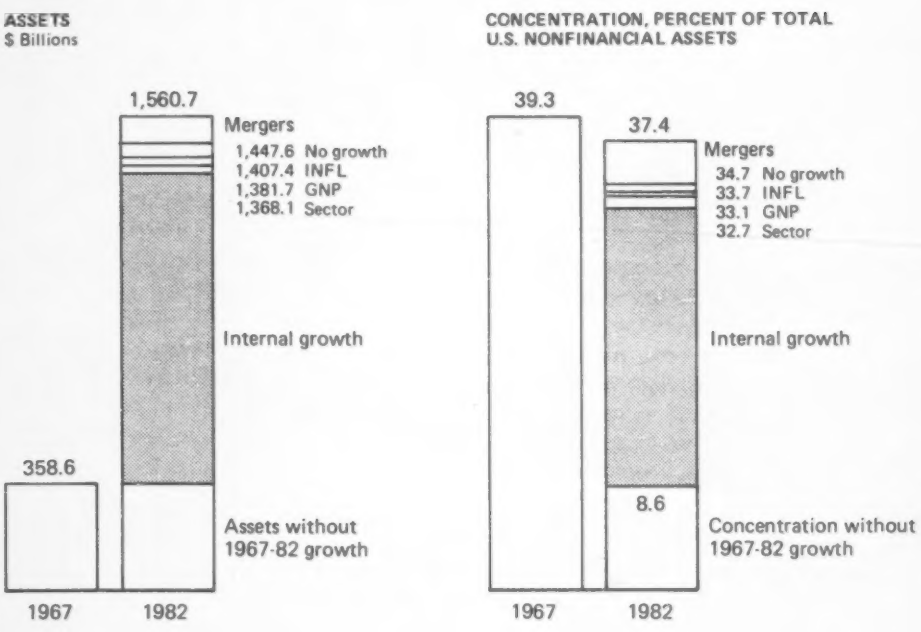

Exhibit 35

EFFECTS OF MERGERS AND INTERNAL GROWTH ON CHANGES IN AGGREGATE CONCENTRATION, 1967-82

Largest 200 Manufacturers/Sales

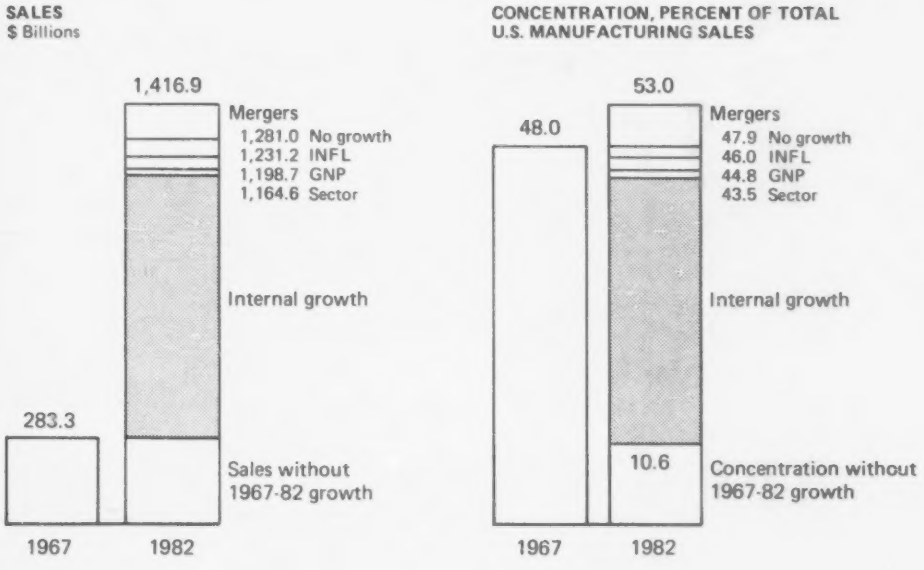

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Exhibit 36

EFFECTS OF MERGERS AND INTERNAL GROWTH ON CHANGES IN AGGREGATE CONCENTRATION, 1967-82

Largest 200 Manufacturers/Assets

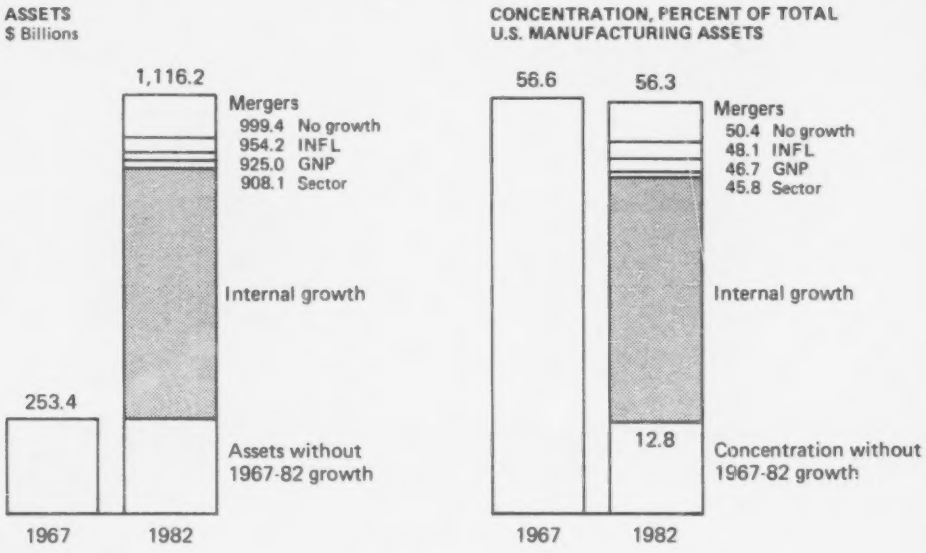


Exhibit 37

EFFECTS OF MERGERS AND INTERNAL GROWTH ON CHANGES IN AGGREGATE CONCENTRATION, 1967-82

Largest 200 Financial Institutions/Sales

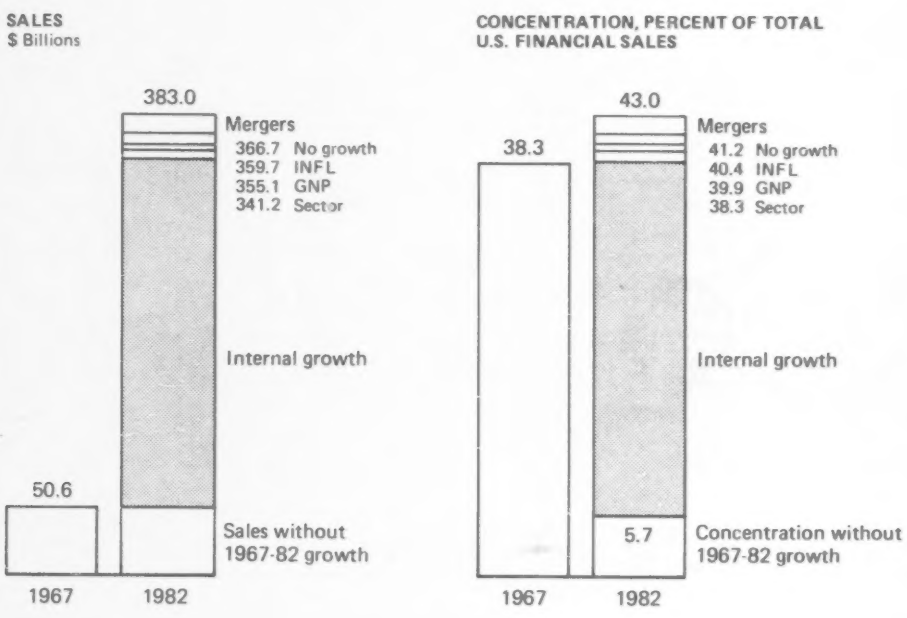
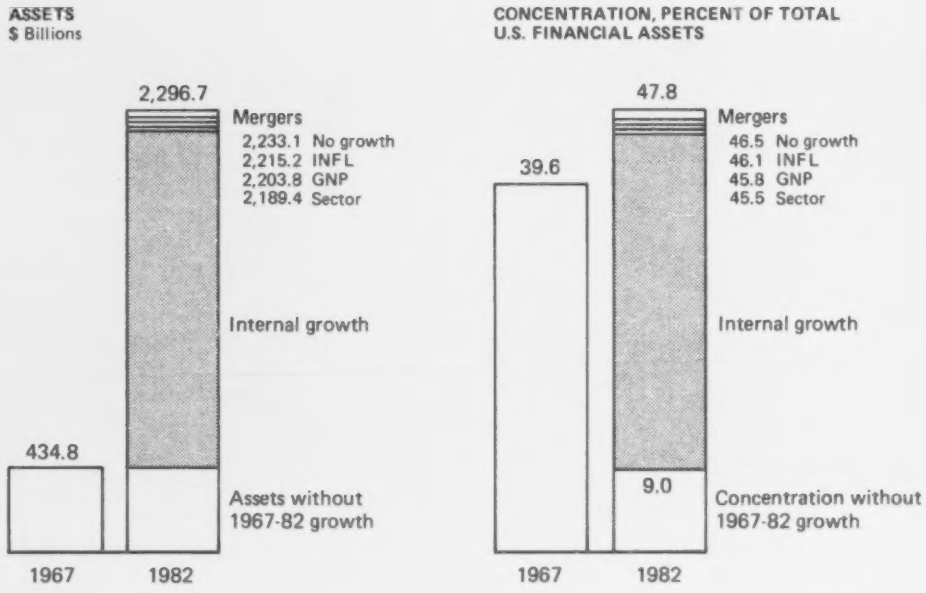


Exhibit 38

EFFECTS OF MERGERS AND INTERNAL GROWTH ON CHANGES IN AGGREGATE CONCENTRATION, 1967-82

Largest 200 Financial Institutions/Assets



Appendix A

METHODOLOGY

This appendix provides methodological background to the analyses presented in the report. It addresses two subjects: data bases and denominators.*

DATA BASES

Morgan Stanley & Co. Incorporated developed and automated two data bases. The first included the largest publicly held U.S. companies ranked by sales and assets; the second included each merger in which the acquired U.S. company had assets or sales of $100 million or more in 1983 dollars.

Large Companies Data Base

Rankings of the largest publicly held companies by sales and assets were developed for eight base years: 1967, 1970, 1972, 1974, 1976, 1978, 1980 and 1982. The data base contains entries for 1,407 companies, including the largest 500 companies in the economy as well as the largest 200 nonfinancial companies, the largest 200 manufacturers, and the largest 200 financial institutions. Sales were defined as total sales or revenues excluding excise taxes. Assets were defined as "total consolidated assets." COMPUSTAT, a service of Standard & Poor's, served as the major source for the sales and assets rankings. The COMPUSTAT - derived data were reviewed and verified by Arthur Young. In consultation with McKinsey, these rankings were subsequently expanded to include mutual companies and others not listed by COMPUSTAT. Fortune and Forbes ranked lists as well as Moody's manuals served as sources for this supplementary data. Where discrepancies arose among sources, figures were drawn from Fortune, Forbes, and Moody's.

COMPUSTAT also served as the source for sector classifications, providing SIC codes for companies in each ranked group. Based on COMPUSTAT coding, companies were classified into six sectors: manufacturing, finance, retailing, utilities, transportation, and services, paralleling the original report. Manufacturing and finance sectors were

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* Refer to Appendix A of the original report for background on measures, adjustments (for inherent overstatement in the concentration ratios), and calculation of merger impact, all of which remain applicable to this report.

further disaggregated. Manufacturing companies were assigned to eight industries: petroleum, vehicles, electronics, food, chemicals, metals, aerospace, and "other". Financial institutions were sorted into three industries: banks, insurance, and diversified financial. Companies drawn from Forbes and Fortune were classified into the same sectors, based on Moody's financial figures. The criterion for a company's sector classification was 50 percent of sales in that sector as reported in Moody's for the appropriate year.

Large Mergers Data Base

The merger data base includes completed transactions from 1965 through 1983 by companies in all sectors with acquired assets or sales of $100 million or more in 1983 dollars. The data base was developed in two major phases.

The first phase involved the collection of completed transactions for the years 1965 to 1982 where acquired sales or assets were equal to or greater than $100 million in 1978 dollars. These transactions were based on the criterion developed by McKinsey in the original report. Transactions were identified for inclusion for the years 1965 through 1978 using annual issues of the Federal Trade Commission's Statistical Report on Mergers and Acquisitions and for the years 1979 through 1982 using The Journal of Corporate Venture. Transactions involving foreign acquirers were included as well as transactions involving sales of subsidiaries or assets. The merger data base does not include leveraged buyouts; U.S. domestic company acquisitions of foreign acquirees; reincorporation of companies into bank holding companies; or transactions in which a company acquired the remaining stock of a company it already controlled.

Whenever possible, the acquired company's sales, assets, and SIC code for the most recent fiscal year prior to the transaction were obtained from COMPUSTAT, which was the primary source of financial information throughout the data bases. Where financial information was not available through COMPUSTAT, the following sources were referred to: Journal of Corporate Venture, Moody's, Dun & Bradstreet's Million Dollar Directory, S&P Register, Sheshunoff 1,000 Largest Savings & Loans, Wall Street Journal, New York Times, proxies, annual reports and 8K filings. Each company was categorized into sectors equivalent to those in the large company data base. The transactions compiled in the first phase were reviewed and verified by Arthur Young.

In the second data collection phase, carried out in consultation with McKinsey, the criterion was revised to include completed transactions with acquired sales or assets of $100 million or more in 1983 dollars. The purpose of this change was to provide the most comprehensive and timely data for this report. The conversion to 1983 dollars had the effect of lowering the threshold for the years 1965 to 1982 and required the addition of over 200

transactions. To illustrate, using acquired assets or sales of $100 million or more in 1978 dollars as the criterion, 1965 acquisitions of $50.5 million or more (in 1965 dollars) would qualify for inclusion. Whereas, using acquired assets or sales of $100 million or more in 1983 dollars as the criterion, 1965 acquisitions of $34.9 million or more (in 1965 dollars) are included. The result is an enlarged data base for the years 1965 to 1982 as well as the addition of 1983 transactions. Sources for mergers that were added to meet the revised criterion as well as for 1983 mergers included annual reports, SEC filings, proxy statements, the Journal of Corporate Venture, and Moody's.

A total of 1,319 domestic and 125 foreign transactions are represented. Acquired assets data were unavailable for 170 additional domestic transactions and acquiring assets data were unavailable for 110 additional domestic transactions; 26 transactions fell into both categories. Acquired assets data were unavailable for 18 additional foreign transactions and acquiring assets data were unavailable for 44 additional foreign transactions, including 7 transactions for which neither acquired nor acquiring assets data were available.

DENOMINATORS

Two sets of denominators were used for calculating concentration ratios: (1) total assets and sales of all U.S. corporations and (2) total assets and sales of U.S. nonfinancial, U.S. manufacturing, and U.S. financial corporations. For the years 1967 through 1980 the data were available through the Internal Revenue Service Statistics of Income. The sources of the IRS data are corporate tax returns. Denominators for the years 1981 to 1983 have not yet been published and were estimated.

In the original report, denominator estimates were made for the years 1976 and 1977. Those projections assumed a stable relationship between corporate sales/assets and the GNP. More recently released IRS annual totals for 1976 through 1980 reveal that the sales/GNP relationship has altered, while assets have maintained a relatively stable relationship to GNP.

The projection methods for the 1981 to 1983 denominators were developed accordingly. Total U.S. sales, manufacturing sales, and nonfinancial sales were developed through a regression against time. Total U.S. assets as well as manufacturing, financial, and nonfinancial assets were developed through a regression against GNP. Projections for financial sales denominators posed a particular problem. Because record-level interest rates in 1981 and 1982 had a direct effect on interest income, the primary component of financial sales, historical data used in regression analysis proved invalid. For this reason, 1980 financial sales were used as the base year for estimating 1981 and 1982 denominators by applying the compound annual growth rate for financial sales for the years 1967 to 1980. This method generated a 1982 denominator larger than the regression method and thus, more accurately captured the impact of high interest rates.

Appendix B

SUPPLEMENTARY DATA

This appendix provides additional data on each group of ranked companies.

For the largest 500 companies, the largest 200 nonfinancial companies, the largest 200 manufacturers, and the largest 200 financial institutions, the following data are provided.

Number of companies in each sector or industry, 1982
Share of concentration, 1982, by size ranking
Share of concentration, 1982, by sector or industry
Change in concentration, 1967-1982, by size ranking
Change in concentration, 1967-1982, by sector or industry
Number of entrants, 1967-1982, by sector or industry
Changes in rankings, 1967-1982, long-tenure companies
Merger frequency by number of acquisitions, 1965-1983, by sales
Merger frequency by number of acquisitions, 1965-1983, by assets.

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LARGEST 500 COMPANIES

NUMBER OF COMPANIES IN EACH SECTOR, 1982

	BY SECTOR						
	Manufacturing	Finance	Utilities	Transportation	Retail	Services	Total
Sales	275	72	65	19	45	24	500
Assets	168	224	77	12	12	7	500

SHARE OF CONCENTRATION, 1982

Percent of Total U.S. Corporate Sales, Assets

	BY SIZE RANKING							BY SECTOR						
	1 - 50	51 - 100	101 - 200	201 - 300	301 - 400	401 - 500	Total Concentration	Manufacturing	Finance	Utilities	Transportation	Retail	Services	Total
Sales	15.3	4.7	5.8	3.8	2.6	1.9	34.1	21.7	4.3	3.5	0.8	3.0	0.8	34.1
Assets	22.4	6.4	7.0	4.5	3.3	2.5	46.1	12.1	26.5	5.8	0.6	0.9	0.2	46.1

CHANGE IN CONCENTRATION, 1967-82

Percentage Point Difference

	BY SIZE RANKING							BY SECTOR						
	1 - 50	51 - 100	101 - 200	201 - 300	301 - 400	401 - 500	Total Change	Manufacturing	Finance	Utilities	Transportation	Retail	Services	Total Change
Sales	0.3	(0.2)	(0.3)	0.1	0.1	0.0	0.0	(2.0)	1.4	1.2	0.1	(0.9)	0.2	0.0
Assets	1.9	1.0	0.4	0.2	0.4	0.5	4.4	(0.6)	4.9	0.2	(0.3)	0.1	0.1	4.4

NUMBER OF ENTRANTS, 1967-82

	BY SECTOR						Totals	
	Manufacturing	Finance	Services	Utilities	Transportation	Retail	Number of Entrants	Entrants as % of 500
Sales	66	38	15	28	7	15	169	34
Assets	32	72	5	12	3	3	127	25

CHANGES IN RANKINGS, 1967-82 LONG-TENURE COMPANIES

	NUMBER OF PLACES MOVED WITHIN RANKINGS				
	0-5	6-25	26-50	Over 50	Total Companies
Sales	26	60	43	202	331
Assets	48	70	60	195	373

MERGER FREQUENCY BY NUMBER OF ACQUISITIONS BY SALES, BY ASSETS, 1965-83

Acquisitions Per Acquiring Firm	Number of Acquiring Firms		Number of Acquisitions From					
			1965-73		1974-83		1965-83	
	BY SALES	BY ASSETS	BY SALES	BY ASSETS	BY SALES	BY ASSETS	BY SALES	BY ASSETS
1	119	103	51	30	68	73	119	103
2	56	52	39	31	73	73	112	104
3	31	29	48	35	45	52	93	87
4	14	14	22	22	34	34	56	56
5	12	10	30	25	30	25	60	50
6	6	6	20	20	16	16	36	36
7	2	2	8	8	6	6	14	14
8	2	3	5	10	11	14	16	24
9	0	0	0	0	0	0	0	0
10	0	0	0	0	0	0	0	0
11	1	1	10	10	1	1	11	11
12	1	1	7	7	5	5	12	12
Total	244	221	240	198	289	299	529	497

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LARGEST 200 NONFINANCIAL COMPANIES

NUMBER OF COMPANIES IN EACH SECTOR, 1982

	Manufacturing	Utilities	Transportation	Retail	Services	Total
Sales	137	25	11	22	5	200
Assets	121	58	11	8	2	200

SHARE OF CONCENTRATION, 1982

Percent of Total U.S. Corporate Sales, Assets

	BY SIZE RANKING					BY SECTOR					
	1 - 50	51 - 100	101 - 150	151 - 200	Total	Manufacturing	Utilities	Transportation	Retail	Services	Total
Sales	14.5	4.1	2.9	2.3	23.8	18.0	2.5	0.6	2.4	0.3	23.8
Assets	10.7	3.1	2.2	1.6	17.6	10.9	5.3	0.5	0.8	0.1	17.6

Percent of Total U.S. Nonfinancial Sales, Assets

	BY SIZE RANKING					BY SECTOR					
	1 - 50	51 - 100	101 - 150	151 - 200	Total	Manufacturing	Utilities	Transportation	Retail	Services	Total
Sales	16.4	4.6	3.2	2.5	26.7	20.3	2.7	0.7	2.7	0.3	26.7
Assets	22.6	6.7	4.6	3.5	37.4	23.1	11.3	1.2	1.6	0.2	37.4

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CHANGE IN CONCENTRATION, 1967-82

Percentage Point Difference
Percent of Total U.S. Corporate Sales, Assets

	BY SIZE RANKING					BY SECTOR					
	1 - 50	51 - 100	101 - 150	151 - 200	Total Change	Manufacturing	Utilities	Transportation	Retail	Services	Total Change
Sales	0.2	(0.4)	(0.4)	(0.2)	(0.8)	(1.1)	0.9	0.1	(0.7)	0.0	(0.8)
Assets	(0.1)	(0.1)	(0.1)	0.1	(0.2)	(0.3)	0.1	(0.2)	0.2	0.0	(0.2)

Percentage Point Difference
Percent of Total U.S. Nonfinancial Sales, Assets

	BY SIZE RANKING					BY SECTOR					
	1 - 50	51 - 100	101 - 150	151 - 200	Total Change	Manufacturing	Utilities	Transportation	Retail	Services	Total Change
Sales	0.5	(0.4)	(0.4)	(0.2)	(0.5)	(1.0)	1.1	0.1	(0.7)	0.0	(0.5)
Assets	(1.1)	(0.4)	(0.3)	(0.1)	(1.9)	(1.5)	(0.2)	(0.5)	0.3	0.0	(1.9)

NUMBER OF ENTRANTS, 1967-82

	BY SECTOR					Totals	
	Manufacturing	Utilities	Transportation	Retail	Services	Number of Entrants	Entrants as % of 200
Sales	36	17	3	8	3	67	34
Assets	32	12	3	4	1	52	26

CHANGES IN RANKINGS, 1967-82 LONG-TENURE COMPANIES

	NUMBER OF PLACES MOVED WITHIN RANKINGS			
	0 - 5	6 - 25	Over 25	Total Companies
Sales	23	39	71	133
Assets	28	39	81	148

MERGER FREQUENCY BY NUMBER OF ACQUISITIONS BY SALES, BY ASSETS, 1965-83

Acquisitions Per Acquiring Firm	Number of Acquiring Firms		Number of Acquisitions From					
			1965-73		1974-83		1965-83	
	BY SALES	BY ASSETS	BY SALES	BY ASSETS	BY SALES	BY ASSETS	BY SALES	BY ASSETS
1	57	46	23	15	34	31	57	46
2	25	17	20	15	30	19	50	34
3	15	15	23	21	22	24	45	45
4	7	6	13	16	15	8	28	24
5	8	7	18	15	22	20	40	35
6	3	3	11	11	7	7	18	18
7	2	2	8	8	6	6	14	14
8	1	1	5	5	3	3	8	8
9	0	0	0	0	0	0	0	0
10	0	0	0	0	0	0	0	0
11	1	1	10	10	1	1	11	11
12	1	1	7	7	5	5	12	12
Total	120	99	138	123	145	124	283	247

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LARGEST 200 MANUFACTURING COMPANIES

NUMBER OF COMPANIES IN EACH INDUSTRY, 1982

	Petroleum	Vehicles	Electronics	Food	Chemicals	Metals	Aerospace	Other	Total
Sales	29	11	21	25	29	12	12	61	200
Assets	29	12	18	18	32	11	10	70	200

SHARE OF CONCENTRATION, 1982

Percent of Total U.S. Corporate Sales, Assets

	BY SIZE RANKING					BY INDUSTRY								
	1 - 50	51 - 100	101 - 150	151 - 200	Total	Petroleum	Vehicles	Electronics	Food	Chemicals	Metals	Aerospace	Other	Total
Sales	12.9	3.3	2.2	1.6	20.0	6.9	2.1	1.8	1.7	2.0	0.8	0.7	4.0	20.0
Assets	8.0	2.2	1.4	1.0	12.6	4.2	1.1	1.1	0.6	1.4	0.6	0.4	3.2	12.6

Percent of Total U.S. Manufacturing Sales, Assets

	BY SIZE RANKING					BY INDUSTRY								
	1 - 50	51 - 100	101 - 150	151 - 200	Total	Petroleum	Vehicles	Electronics	Food	Chemicals	Metals	Aerospace	Other	Total
Sales	34.1	8.9	5.9	4.1	53.0	18.4	5.6	4.7	4.4	5.3	2.2	1.8	10.6	53.0
Assets	35.6	9.8	6.4	4.5	56.3	18.7	5.0	4.8	2.7	6.4	2.8	1.6	14.3	56.3

CHANGE IN CONCENTRATION, 1967-82

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Percentage Point Difference
Percent of Total U.S. Corporate Sales, Assets

	BY SIZE RANKING					BY INDUSTRY								
	1 - 50	51 - 100	101 - 150	151 - 200	Total Change	Petroleum	Vehicles	Electronics	Food	Chemicals	Metals	Aerospace	Other	Total Change
Sales	0.7	(0.6)	(0.4)	(0.3)	(0.6)	3.2	(1.5)	(0.1)	(0.6)	(0.1)	(0.7)	(0.3)	(0.5)	(0.6)
Assets	0.1	(0.2)	0.1	0.0	0.0	0.7	(0.6)	0.2	(0.1)	0.2	(0.7)	0.0	0.3	0.0

Percentage Point Difference
Percent of Total U.S. Manufacturing Sales, Assets

	BY SIZE RANKING					BY INDUSTRY								
	1 - 50	51 - 100	101 - 150	151 - 200	Total Change	Petroleum	Vehicles	Electronics	Food	Chemicals	Metals	Aerospace	Other	Total Change
Sales	5.7	(0.4)	(0.2)	(0.1)	5.0	9.6	(2.9)	0.3	(0.9)	0.5	(1.2)	(0.6)	0.2	5.0
Assets	0.4	(0.9)	0.2	0.0	(0.3)	3.1	(2.5)	0.8	(0.4)	0.8	(3.2)	(0.2)	1.3	(0.3)

NUMBER OF ENTRANTS, 1967-82

	BY INDUSTRY								Totals	
	Petroleum	Vehicles	Electronics	Food	Chemicals	Metals	Aerospace	Other	Number of Entrants	Entrants as % of 200
Sales	13	0	8	5	9	1	2	15	53	26
Assets	9	0	7	3	7	0	1	20	47	24

CHANGES IN RANKINGS, 1967-82 LONG-TENURE COMPANIES

	NUMBER OF PLACES MOVED WITHIN RANKINGS			
	0 - 5	6 - 25	Over 25	Total Companies
Sales	21	52	74	147
Assets	28	47	78	153

MERGER FREQUENCY BY NUMBER OF ACQUISITIONS BY SALES, BY ASSETS, 1965-83

Acquisitions Per Acquiring Firm	Number of Acquiring Firms		Number of Acquisitions From					
			1965-73		1974-83		1965-83	
	BY SALES	BY ASSETS	BY SALES	BY ASSETS	BY SALES	BY ASSETS	BY SALES	BY ASSETS
1	61	61	29	22	32	39	61	61
2	24	24	21	21	27	27	48	48
3	18	20	34	33	20	27	54	60
4	8	8	17	19	15	13	32	32
5	12	11	30	26	30	29	60	55
6	4	4	17	17	7	7	24	24
7	2	2	8	8	6	6	14	14
8	1	1	5	5	3	3	8	8
9	0	0	0	0	0	0	0	0
10	0	0	0	0	0	0	0	0
11	1	1	10	10	1	1	11	11
12	1	1	7	7	5	5	12	12
Total	132	133	178	168	146	157	324	325

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LARGEST 200 FINANCIAL INSTITUTIONS

NUMBER OF COMPANIES IN EACH INDUSTRY, 1982

	Banks	Insurance	Diversified	Total
Sales	103	67	30	200
Assets	123	47	30	200

SHARE OF CONCENTRATION, 1982

Percent of Total U.S. Corporate Sales, Assets

	BY SIZE RANKING					BY INDUSTRY			
	1 - 50	51 - 100	101 - 150	151 - 200	Total	Banks	Insurance	Diversified	Total
Sales	3.9	0.8	0.4	0.3	5.4	2.3	1.8	1.3	5.4
Assets	18.0	3.9	2.4	1.6	25.9	15.9	6.0	4.0	25.9

Percent of Total U.S. Financial Sales, Assets

	BY SIZE RANKING					BY INDUSTRY			
	1 - 50	51 - 100	101 - 150	151 - 200	Total	Banks	Insurance	Diversified	Total
Sales	31.0	6.4	3.4	2.2	43.0	18.3	14.1	10.6	43.0
Assets	33.2	7.3	4.4	2.9	47.8	29.4	11.1	7.3	47.8

CHANGE IN CONCENTRATION, 1967-82

Percentage Point Difference
Percent of Total U.S. Corporate Sales, Assets

	BY SIZE RANKING					BY INDUSTRY			
	1 - 50	51 - 100	101 - 150	151 - 200	Total Change	Banks	Insurance	Diversified	Total Change
Sales	1.0	0.3	0.2	0.2	1.7	1.5	(0.6)	0.8	1.7
Assets	2.9	0.6	0.4	0.4	4.3	3.6	(1.9)	2.6	4.3

Percentage Point Difference
Percent of Total U.S. Financial Sales, Assets

	BY SIZE RANKING					BY INDUSTRY			
	1 - 50	51 - 100	101 - 150	151 - 200	Total Change	Banks	Insurance	Diversified	Total Change
Sales	1.4	1.5	1.0	0.8	4.7	10.2	(10.3)	4.8	4.7
Assets	5.4	1.2	0.8	0.8	8.2	6.8	(3.4)	4.8	8.2

NUMBER OF ENTRANTS, 1967-82

	BY INDUSTRY			Totals	
	Banks	Insurance	Diversified	Number of Entrants	Entrants as % of 200
Sales	24	27	15	66	33
Assets	26	18	17	61	31

CHANGES IN RANKINGS, 1967-82 LONG-TENURE COMPANIES

	NUMBER OF PLACES MOVED WITHIN RANKINGS			
	0 - 5	6 - 25	Over 25	Total Companies
Sales	13	61	60	134
Assets	33	50	56	139

MERGER FREQUENCY BY NUMBER OF ACQUISITIONS BY SALES, BY ASSETS, 1965-83

Acquisitions Per Acquiring Firm	Number of Acquiring Firms		Number of Acquisitions From					
			1965-73		1974-83		1965-83	
	BY SALES	BY ASSETS	BY SALES	BY ASSETS	BY SALES	BY ASSETS	BY SALES	BY ASSETS
1	34	39	7	10	27	29	34	39
2	24	25	9	10	39	40	48	50
3	8	9	4	5	20	22	24	27
4	7	7	3	4	25	24	28	28
5	1	1	2	4	3	1	5	5
6	2	2	3	3	9	9	12	12
7	0	0	0	0	0	0	0	0
8	2	2	1	5	15	11	16	16
9	0	0	0	0	0	0	0	0
10	0	0	0	0	0	0	0	0
11	0	0	0	0	0	0	0	0
12	0	0	0	0	0	0	0	0
Total	78	85	29	41	138	136	167	177

Mr. FLIPPO. Let me ask you if you don't think that the Tax Code stimulates companies to capitalize themselves with more debt than they would in the absence of an income tax?

Mr. GLEACHER. I think it does. I would like to make a comment. There has been a lot of talk today about restructuring and would you allow the deductibility of interest when a company restructures. Well, it is all a tradeoff. For example, when Phillips restructured, it redeemed half of its stock for debt. The interest on that debt reduces its taxable income, thereby reducing its taxes. However, the net taxes that the Government receives increases for two reasons. First the shareholders who turned in half their stock pay a capital gain on the difference between what they got and what their basis was.

Second, the interest paid on that debt goes to somebody every year. That somebody pays taxes on it.

Mr. FLIPPO. If you were——

Chairman PICKLE. Well, that wasn't true earlier. Mr. Pickens said that he made $700 or $800 million and he didn't pay any taxes on his company.

Mr. GLEACHER. There I think we are getting into apples and oranges. That is another point.

I don't know what Mr. Pickens' tax situation is, but he has an oil company, and the oil business is set up with various tax deductions to give incentives for people to drill for oil. Evidently, he is drilling for a lot of oil and he has reduced his taxable income.

One point that was made earlier was whether Mr. Pickens would have spent a lot more money to carry his investment positions in his targets if he was unable to deduct the interest on borrowed money. The point is, if he doesn't pay any taxes, he has no taxable income to deduct those interest costs from anyway. Therefore, he is not getting a current tax break from the interest expense. It is as if there is no tax deductibility available to him at all.

Mr. FLIPPO. Let me come back and ask you, is it possible to increase the debt, buy back this stock, increase your interest cost, reduce your taxes, increase your cash-flow, and in fact increase the return on investment to the remaining stockholders, through no other change, no economic change other than the substitution of debt for equity?

Mr. GLEACHER. It probably is true.

Mr. FLIPPO. If you increase the return on investment potential to the investor, or the stockholder, then the market would capitalize that, wouldn't it, and increase the value of the stock?

Mr. GLEACHER. It might. It depends on how much debt is involved, how risky they think——

Mr. FLIPPO. Of course. I understand that. I understand that, but isn't that a situation where the price of the stock is raised with no other transaction except the substitution of debt for equity?

In that situation, then, isn't that a means of bringing an undervalued stock more nearly to a "market" value? Is that a reasonable thing that I am talking about?

Mr. GLEACHER. I think that is what Mr. Pickens' thesis is.

Mr. FLIPPO. OK. Then how can you say that the Tax Code and the deductibility of interest is not a driving factor in that—I hate to use the word "scheme"—in that technique, if you would?

Mr. GLEACHER. Because what I am talking about, and what I believe my colleagues are talking about, are other types of mergers and acquisitions.

Mr. FLIPPO. Yes. Well——

Mr. GLEACHER. The stock market is cyclical; the merger business is cyclical; the world is cyclical.

Mr. FLIPPO. Yes.

Mr. GLEACHER. When stock prices go down, many companies go out and repurchase their own stock.

Mr. FLIPPO. Let me come back to junk bonds. I believe your company is now participating somewhat in issuing junk bonds, and probably all companies are.

What does your company consider the security for the junk bonds? Do you consider the assets of the target company?

Mr. GLEACHER. The assets of the issuer of the security for the junk bonds.

Mr. FLIPPO. You do not consider the assets of the target companies, the potential—you do not take into consideration the fact that the target company would be merged and those assets would be available to the issuing company?

Mr. GLEACHER. I will say two things. First of all, we have never represented anyone with this type of a transaction. We trade junk bonds because our clients, our investor clients, want to invest in them. Second, we are issuing them to finance companies. We have never used them in a hostile takeover.

But I think you are right. I agree with you that some people who pay commitment fees or get commitment fees are in their minds saying they will put up the money if certain things happen. Whether it is theoretical or legal, they are saying, "We are not really going to put up the money unless the deal is successful." Then they are looking to the assets of the target company at least indirectly.

Chairmman PICKLE. Would the gentleman yield?

Mr. FLIPPO. Yes, sir.

Chairman PICKLE. We've had it said here today that these high-yield bonds or the junk bonds are really closer to equity than to debt. Do you agree or disagree with that?

Mr. GLEACHER. I disagree with that. I think they are debt.

Chairman PICKLE. Do you all disagree or do you all agree with that?

Mr. PERLMUTTER. I would say they are not akin to equity. It is an obligation. It is a fixed obligation of the issuer. He has to service it. Equity dividends vary depending upon the circumstances of the corporation. Equity is not redeemed at a point in time. Equity stays out. Debt must be redeemed at a fixed point in time. So it really is an obligation. It has debt characteristics. It enhances the risk of doing business. It is a cost of doing business. All of those are characteristics of true debt.

I think the answer, if I may just go back for a second to this junk bond financing, and what is the security for the financing, it is very hard to generalize. Obviously, some of these issuers have sufficient financial strength on their own balance sheet to issue and raise sufficient funds, but I think it is fair to say that in some circumstances the junk bond financing is conditioned upon the acqui-

sition of the target company and its assets that thereafter would be controlled and available for service of that debt.

But, frankly, that in and of itself does not necessarily cause concern. I guess some of this discussion is, to some extent, a little bit like looking at modern art—it is in the eyes of the beholder whether these kinds of things are good or bad.

Mr. FLIPPO. Well, that is really not what we are trying to do here. I wouldn't know that I would want to change the law even if that is the way it was. I am really trying to understand what is going on out there. I am not trying to talk in legal terms or technical terms. I am trying to really understand what is motivating that.

In my mind, what is motivating it is that we have some assets that someone has decided are undervalued, and perhaps they are. We use the technique of substituting debt for equity and the tax advantages and the cash flow and the return on equity to the remaining stockholders that is reflected in the capitalized value in the marketplace, and that is the way of pulling out or moving that stock price. If that is not right, help me understand it.

Mr. PERLMUTTER. I would say, if I may, just on that point, the stock price does not automatically increase in value because of a junk bond financing. The stock price has the potential of increasing if the proceeds of that junk bond financing are invested wisely and well to the benefit of the company by increased earnings, and a higher return on assets.

But the mere fact of the financing does not in and of itself increase the stock price, nor does it increase cash flow.

Mr. FLIPPO. I will make just one final point, Mr. Chairman. You have been very tolerant.

I wonder if you could issue the junk bonds if you didn't have the deductibility of the interest.

Mr. KEILIN. The answer is no, Congressman, you could not.

Mr. FLIPPO. OK.

Mr. KEILIN. But one thing to understand about that more generally is what you say is correct, in some circumstances, in the right company, by issuing debt you can increase the value of the stock. Now that technique is available to Mr. Pickens from the outside. It is also available to the management of the company from the inside under current tax laws.

Management can take a different tact using the same technique. Instead of issuing debt to buy back its stock, it can issue debt to buy new assets, which it expects to earn money for the same number of existing shareholders. That also ought in the long run to improve—and maybe in the short run to improve—the value of its stock.

That is a characteristic of the deductibility of interest for all purposes.

Mr. FLIPPO. Yes.

Mr. KEILIN. If you change that, you obviously change what you can do.

Mr. FLIPPO. But I am not trying to necessarily change that. I am trying to understand it.

I would just make one other final point, and that is probably the difference between a hostile takeover and a friendly takeover is the

level of debt that would be required. Is that one of the main causes of differentiation?

Some companies want a lot of debt to increase their return to stockholders and others don't, I suppose.

Mr. KEILIN. Well, I thought that question was handled in an interesting way when asked of the previous panel. The panel said it is a question of price, whether you maximize the value for the stockholders. There are also, of course, in these transactions a question of who the surviving management is going to be and who is in the best position to run the company for the benefit of the shareholders.

I think the amount of the debt—and, therefore, the price—has some impact on whether you regard something as friendly or hostile, but it is not the only consideration.

Mr. FLIPPO. Thank you very much.

Chairman PICKLE. Mr. McGrath.

Mr. MCGRATH. No questions.

Chairman PICKLE. Gentlemen, we thank you. We are going to submit to you some written questions that we will ask you to comment on. We will ask each of you to submit to us a copy of your written statement if you have not already done so and identifying your clients and whom you work for. We would like for you to make comments if the Tax Code in any way ever has played a prominent part in these mergers or these acquisitions.

[Letters and replies follow:]

COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC, May 13, 1985.

MESSRS. GLEACHER, PERLMUTTER, PROFUSEK, AND KEILIN: Thank you for appearing as a witness at the Subcommittee's hearing on mergers and acquisitions. Your experience and expertise provided the Subcommittee with much valuable analysis and information. For the purpose of completing the Subcommittee's hearing record, I have enclosed a series of additional questions for your response.

I would appreciate your review and response to my office by May 24, 1985. If you have any questions, please contact Bill Cunningham of the Subcommittee staff at 225-5522.

Sincerely yours,

J.J. PICKLE,
Chairman, Subcommittee on Oversight.

Enclosures.

1. In your business of evaluating and pricing mergers, what role do the tax aspects of a deal play? Specifically, which tax provisions are considered in determining whether a merger deal is feasible and desirable?

2. Do you maintain a list of potential target firms? What are their various tax and nontax attributes?

3. In analyzing and pricing mergers:

(a) How do you determine which corporations would be good candidates for acquisition?

(b) What public data do you review? What other sources do you use?

(c) Do you use computer programs in analyzing potential acquisitions or in locating potential targets for your clients? If so, what types of tax information are incorporated in those programs?

4. Once you have obtained the data you need for your analysis, what subjective or other objective tests do you use in making your recommendations to clients?

5. In your opinion, are junk bonds priced correctly? Are there any problems with junk bond financing of which we should be aware? Is junk bond financing used in friendly as well as hostile takeovers? In what percentage of acquisitions are junk bonds used today?

6. Some experts argue that a firm is vulnerable to a takeover when (1) stock is undervalued in relation to its underlying assets; (2) the corporation has a high effective tax rate; or (3) the corporation has substantial liquid assets, including an overfunded pension plan. Do you agree? What other characteristics of a corporation make it an attractive takeover target?

7. Some experts argue that the tax laws encourage debt financing rather than equity financing since corporations are allowed deductions for interest payments but not for payment of dividends.

(a) Do you agree?

(b) Should the Congress restrict or eliminate the deductibility of interest (1) generally; (2) in all mergers; (3) in "hostile takeovers"; or (4) for "junk bonds"? Please explain.

8. If a line were to be drawn for tax purposes between friendly mergers and hostile mergers, how should hostile be defined? Should a vote by the "independent directors" of the target corporation be determinative? If not, what test or standard should we use? Should the tax code distinguish between hostile and friendly mergers?

9. If the deduction for interest payments on junk bonds were denied, do you feel that such denial should apply:

(a) To all junk bonds;

(b) To junk bonds used in connection with any merger or acquisition;

(c) To junk bonds used in connection with any larger merger or acquisition;

(d) To junk bonds used by any target company to repurchase its own stock.

Please explain your answer.

10. Should greenmail payments be prohibited or penalized? If so, should such regulation be done through the securities laws and/or the tax laws?

11. If the interest deduction for junk bonds used in connection with mergers and acquisitions were denied, would fewer of your clients be in a position to proceed with proposed acquisitions? If not, would junk bonds be used despite the interest deduction denial or would other debt or equity instruments be used? Please explain.

12. What characteristics of a company make it a likely target? (a) Undervalued assets; (b) Liquidation potential of separate parts of the company; (c) Poor management; (d) Over-funded pension plans; (e) Large cash reserves; (f) Low debt/equity ratio.

MORGAN STANLEY & CO., INC.,
New York, NY, May 31, 1985.

Hon. J.J. PICKLE,
Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: I am pleased to respond to your letter of May 13, 1985, in which you posed a series of additional questions in connection with the Subcommittee's hearings on mergers and acquisitions. My answers below are numbered in a manner corresponding to your questions.

1. When I evaluate and price mergers and acquisitions, I am concerned solely with the business reasons for and financial impact of the deal. Only after these concerns are satisfied does someone evaluate and suggest changes to maximize the tax benefits which may be available.

2. We do not maintain a list of potential target firms, per se. Instead, we are constantly evaluating a large number of companies for their investment potential. We are also looking for potential acquisitions for some of our clients who have expressed such an interest. If a company's market value is substantially less than its asset value, we will note it and may inform them and/or our clients.

3.(a) In analyzing and pricing mergers, the primary consideration is to find a target whose assets have not been adequately valued by the financial markets. When the whole is valued at far less than the sum of its parts, it is a prime candidate.

(b) We review all of the public data we can obtain, including filings with the SEC, annual reports, articles in the press, and Standard & Poors and Moody's reports.

(c) Like all sophisticated money managers and financial analysists, we use computers extensively in analyzing potential acquisitions and sifting through financial data to find potential opportunities. However, these programs contain little, if any, tax information. In fact, since corporations do not routinely list their actual tax liability or release their tax returns, such information is rarely available.

4. The three main considerations we have in analyzing a potential acquisition for one of our clients are (a) whether the target is undervalued by the market relative to its underlying values; (b) whether it is a sound and profitable business; and (c)

will it fit within the acquiror's business structure and strategy, i.e., the synergies. If the target has more than one business, we may also look at whether and how some of the business may be divested.

5. The market is the best judge of whether junk bonds are priced correctly. The greater the risk taken by an investor, the greater the rewards should be. Common stocks offer the greatest potential return because they bear the highest risk. Junk bonds pay higher rates of interest because the risk is greater than federally insured CD's or T-bills.

Although junk bonds have been proposed and commitments received in a few highly publicized takeover contests, I do not know that they have ever actually been issued in a successful hostile acquisition. Generally, for various reasons, these takeover attempts do not proceed; the markets recognize the worth or lack of worth of these securities.

6. A firm is clearly vulnerable to a takeover when its stock is undervalued in relation to its underlying assets, particularly when those assets may easily be divested and operated by other entities. This vulnerability is increased if a substantial portion of the firm's assets are liquid, regardless of the source of the liquidity.

A firm may be vulnerable to a takeover if it has a high effective tax rate, not because of its tax position but because it must be highly profitable to be in that position. If I could acquire a firm with a very low effective tax rate which is equally as profitable, I may be better off because the cash flow from my investment would be increased. Thus, the potential cash flow and profit of the target are far more important than its tax posture.

7.(a) It may well be that the double taxation under our tax laws encourages debt financing over equity financing. However, investors in the financial markets have a strong bias against overleveraging corporations. Accordingly, most executives of corporations are uncomfortable with increasing their debt-equity ratios too high. Therefore, I do not see this bias in the tax laws as affecting the capital structure of most public corporations.

(b) I do not believe that Congress should change the law to restrict the interest deduction. It would be wrong to measure and tax income without permitting as a deduction a legitimate cost of earning that income. No distinction should be drawn between mergers and other transactions, whether friendly or hostile, or through the use of junk bonds versus higher quality debt instruments.

8. I feel that no line should be drawn between friendly and hostile mergers. Any attempt to define "hostile" would be futile. First, boards of directors are largely self-perpetuating, so the "independent director" may not always be so independent. Second, if you draw such a line, you will put more rather than less power in the hands of hostile bidders who could make two offers for stock, with the higher price contingent on the board's acceptance. In addition, you would discourage higher competing bids to a friendly acquisition offer because the uninvited bidder may not be able to deduct its interest expense.

9. In general, I do not believe the deduction for interest payments on junk bonds should be denied, except perhaps when the bonds are in fact equity under current legal standards.

10. I do not believe it is necessary to pass a law prohibiting the payment of greenmail. The marketplace is now regulating itself. Many corporations have passed resolutions or by-law amendments barring the payment of greenmail. Others have recognized that once a corporation succumbs to paying greenmail to one party, others will soon follow and shareholders will sue the board and the greenmailer.

If Congress insists on passing a law against greenmail, it should do so directly through the securities law, rather than indirectly through the tax law. In drafting such legislation, you should note that greenmail may be paid indirectly.

Finally, while we believe that greenmail payments are not deductible under current law, we would not object to a tax law amendment clarifying that they are not deductible.

11. Our clients have not used junk bonds in connection with their mergers and acquisitions. If the interest deduction for junk bonds used in connection with mergers and acquisitions were denied, it would probably help rather than hurt most of our clients. They would be more secure because fewer companies would be able to attempt to acquire them. Only those large companies with sufficient cash reserves and cash flow could make large acquisitions; large companies would be all but invulnerable to acquisitions by smaller (and many larger) companies.

Even without the interest deduction, many acquisitions would proceed in some revised form—whether involving stock, stock and debt, or fights for control through proxy contests.

12. All of the factors listed are relevant considerations in determining whether a company is a likely target.

I hope this is responsive to your questions. If I can be of further service, please do not hesitate to contact me.

With best personal regards.

Sincerely,

ERIC J. GLEACHER.

LAZARD FRERES & CO.,
New York, NY, May 31, 1985.

Hon. J.J. PICKLE,
Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: I am pleased to respond to your letter of May 13, 1985, in which you posed a series of additional questions in connection with the Subcommittee's hearings on mergers and acquisitions. My answers below are numbered in a manner corresponding to your questions.

1. In the public company merger and acquisition area, we consider the tax aspects of a deal only after the business reasons for proceeding have been made and the basic financial impact (such as the effect on the balance sheet and earnings per share) has been analyzed. We initially structure the deal with cash, stock or some combination in light of these concerns. Once these issues are resolved satisfactorily, our objective is to structure the deal in the most tax efficient manner.

In a taxable transaction, the acquiror's primary tax concern is whether to make the Section 338 election. Because of the cost of the tax on recapture, few acquirors in large transactions make this election. Thus, taxes are a lesser concern than they were prior to the changes in the tax law in 1982.

The seller's primary concern is whether a transaction is taxable or not, and if so, whether the gain will be taxable as capital gain or ordinary income. In unsolicited acquisitions, the seller's tax preference is not considered, in negotiated mergers, it becomes a factor only if consistent with the business and financial considerations.

2. We do not maintain a list of targets, as such. However, we closely monitor the markets and follow the progress of companies—whether undervalued by the markets, or not—that operate in areas of interest to our clients.

3. (a) We do not look at corporations and determine whether they are prime targets in a vacuum. Instead, we analyze the long-term business plans and needs of our clients and then examine other companies and their components to determine whether they mesh with our clients' strategies.

(b) We review all of the public data provided by registered companies, including their 10-Q's, 10-K's, annual reports and registration statements, along with information provided by the government, industry groups, stock market analysts, rating services and the media. Also our clients often have information on companies, especially if they are in related industries.

(c) Like all investment banks, we use computers with sophisticated software to gather information on other companies, and to help us perform certain financial analysis. We certainly note the effective tax rate of such companies, but do not conduct elaborate tax analysis, primarily because of lack of sufficient information, and because our clients' interest primarily is industrially driven, not tax driven.

4. The primary test we use in making recommendations to our clients is whether the deal makes business sense. If, over the long-term, a proposed transaction also will enhance per share earnings, the corporate balance sheet and shareholder values, we are likely to make a positive recommendation to our clients.

5. The best way to determine if junk bonds are priced correctly is to look at the market. If the coupon bonds are selling at or near their issue price, they were properly priced; their higher interest rate should reflect their higher risk. Similarly, if zero coupon bonds are selling for their issue price plus accrued interest, they were properly priced.

Although they are highly publicized when used or proposed, junk bond financing is rarely involved in financing acquisitions, whether friendly or hostile. A transaction can not be characterized as "friendly" or "hostile" by whether or not junk bonds are used to finance the deal. Whether a deal is friendly or not depends upon the attitude of the target company's management and Board of Directors to the takeover offer.

The main problem I have in the area of the financing of takeovers is with offers that are made subject to financing being secured. Such offers, whether utilizing

junk bonds or not, are conditional, yet have a dramatic impact on the capital markets. The offeror, in fact, may not intend to proceed, but rather may wish to stampede the target into selling to another company at a higher price, or repurchasing at a profit the offeror's shares in the target. To insure that offerors are serious, responsible parties, they should not be allowed to make offers until all their financial plans are final, committed and disclosed.

6. If a firm is not undervalued in relation to its underlying assets, it will almost never be vulnerable to a takeover unless those assets are worth more in the hands of another because of synergies or other operating efficiencies. In comparison, a firm whose stock is undervalued relative to its assets and has substantial liquid assets indeed is vulnerable. Other relevant characteristics of a corporation which may make it more attractive are its long-term growth prospects, a strong market or technological niche, a strong liquid balance sheet and high cash flow. However, a corporation's effective tax rate is largely irrelevant, except in the relatively rare circumstances where an acquiror has a large net operating loss carryover and is looking for taxable earnings.

7. Any bias in the tax laws in favor of using debt is largely offset by the market's bias against a high debt-equity ratio. If there is a tax incentive in using debt, it results from the double taxation of corporate profits paid out as dividends to shareholders in contrast to the deductibility of interest paid out to creditors. However, this encouragement of debt has existed for a number of years without driving corporate America to over-leverage itself with high debt-equity ratios. Managements of public companies, for the most part, have targeted debt-equity ratios which are designed to achieve and maintain sufficient financial strength to be in a position to finance opportunities that arise at the lowest cost possible. Privately owned companies have more flexibility and can live more comfortably with higher debt levels, and it is certainly true that high debt-to-equity ratios increase the risk of vulnerability to economic downturns. However, there is no credible evidence that the leveraging of corporate America has reached such proportions as to be dangerous enough to be curtailed by legislation.

I do not believe Congress should restrict or eliminate the deductibility of interest in any mergers, acquisitions or use of junk bonds. Tax consequences should follow the economics of a transaction, rather than diverge from it. There is no logical basis for utilizing the tax laws to differentiate between types of capital investments—acquisition vs the purchase of a new facility, or between a friendly vs "hostile" takeover.

8. No line should be drawn between friendly and hostile mergers or acquisitions. It is impossible to define "hostile" in a manner which makes sense and which would not interfere with the flow of capital and protect shareholders. Further, tax consequences should not depend on whether an acquisition is hostile or friendly, and limiting deductibility of interest expense in a hostile transaction is completely discriminatory. The consequence would be that fewer such transactions would be attempted and at lower prices. Is the tax laws really the appropriate form to decide such critical capital market issues? I think not.

9. I do not feel that the deduction for interest payments should be denied for junk bonds. Many smaller, emerging companies without sufficient size to enjoy a strong credit rating need to finance their operations through the issuance of debt securities in the capital markets. This is an essential process for growth and has to be encouraged. However, if a corporation is undercapitalized and attempts a takeover of a larger company via junk bonds, then such financing represents equity rather than debt, and the deduction for "interest" should be denied. This situation would occur when a shell corporation with insignificant assets is created to attempt an acquisition via the use of high yield, junior obligations. These so called junk bonds entail high risk, being issued by a highly leveraged, newly formed corporation. In truth they are closer to equity than debt, and should be so treated by the tax laws.

10. I am not certain that legislation is necessary to prevent greenmail. Investors have expressed their disgust with this use of corporate assets. Some corporations have adopted resolutions or bylaw amendments prohibiting greenmail. Greenmail is no longer being used as management realizes that paying off one greenmailer only encourages others and does not "save" the company. This is a good example of how capital markets ultimately adjust to eliminate abuses.

If Congress determines to prohibit or penalize greenmail, it should be done directly though the securities laws.

11. Our clients have not used junk bonds in connection with any mergers or acquisitions. Thus, restricting the deduction for interest on junk bonds would probably not effect their proposed acquisitions. However, if the interest deduction for higher risk securities were to be denied, it would have several consequences. First, it would

limit the market for corporate control to well-financed entities. Second, it would lower the price offered to the target company's shareholders. Finally, acquisitions would still take place only with other types of instruments. More stock for stock transactions probably would occur.

The consequences of not being able to maximize shareholder value and of interfering with the free market's allocation of credit could have such a profound impact on our capital markets that it mandates the most careful and detailed scrutiny before legislation is enacted.

12. All of the listed factors contribute to making a company a potential takeover target.

Sincerely,

LOUIS PERLMUTTER.

RESPONSES OF ROBERT A. PROFUSEK

INTRODUCTION

The information herein responds to a list of supplemental questions submitted by the Subcommittee on Oversight following the undersigned's appearance in the Subcommittee's April 2, 1985 hearings on the tax treatment of mergers and acquisitions. The specific responses below are numbered to correspond to the Subcommittee's supplemental questions. References herein to "WS" are to the written statement of the undersigned submitted to the Subcommittee on April 2, 1985.

The views expressed herein are solely those of the undersigned, and do not necessarily represent the views of Jones, Day, Reavis & Pogue, a law firm of which the undersigned is a Partner, or any of its clients.

RESPONSES

1. Tax aspects of acquisitions, particularly the stepped-up basis provisions of Section 338 and the interest deduction under Section 163 for debt-financed transactions, are elements in the current acquisition wave. (See WS at 9–11.) Other provisions of the present tax laws can be of major significance in particular acquisition transactions. (See WS at 9–10.) However, the tax laws are only one component of a complex mix of factors in the current takeover arena, and rarely are motivating factors for negotiated or hostile acquisitions. (See WS at 14–15; 19–25.)

2. Many acquisition-minded companies maintain lists of potential target companies. It would not be practicable to generalize regarding the tax attributes thereof since those attributes generally are not significant elements of preliminary analyses. (But see Response 6 below.)

3. Most acquisition-minded companies use computer models to analyze potential acquisition candidates. Such analyses are normally based upon publicly available financial information contained in stockholder communications and SEC filings. The primary selection criteria include (in addition to those mentioned in Response 6 below) the businesses and size of the target, business strategies of the potential acquiror, internal-rate-of-return ("IRR") analyses on a cash flow basis (i.e., by elimination of depreciation and other noncash income charges) and possible savings resulting from cost eliminations. The tax information primarily relevant in that analysis is the interest deduction and depreciation deduction (both of which affect cost and IRR analyses). These attributes may affect transaction pricing and result in the elimination of otherwise marginal transactions from further analysis, but again are not normally outcome-determinative. (See WS at 13–15; 19–25.)

4. See Responses 1–3 above. (As a legal advisor in takeover transactions, I am not normally involved in making recommendations of the type referred to in Question 4.)

5. While junk bonds have generated considerable publicity, they are used as the direct source of funds in only a small percentage of takeovers, whether hostile or negotiated. They have been used in friendly transactions and it is extremely difficult, as a matter of tax policy, to justify a distinction in the tax treatment of financing for friendly and unfriendly transactions. (See WS at 18–25.) Whether junk bonds should be treated as true debt or equity for tax purposes, without respect to whether they are used for friendly or unfriendly acquisitions (or for acquisitions at all), perhaps warrants consideration by the Subcommittee. (See Response 9 below.)

6. The identified characteristics are significant, but are not an exclusive listing. Other key criteria include (i) alternative price/value analysis (e.g., the ratio of price to cash flow), (ii) stock ownership, (iii) the existence of shark repellants, requirements for governmental approvals, etc. which may impede an unsolicited takeover

bid, (iv) industry trends (e.g., deregulation in the financial institutions industry, energy industry consolidation, etc.), (v) the quality of a potential target's core businesses, management, etc., (vi) the extent of the potential target's existing leverage, (vii) whether the potential target company has assets which could be disposed of for fair value without adversely affecting its core businesses, and (viii) of equal relevance to all other factors, similar matters affecting the potential bidder. Many other factors can be significant in particular situations. (See WS at 13–15.) In each case, the weighing of particular factors is a function of the particular circumstances presented.

7. In general, the availability of the interest deduction is a factor in any acquiror's decision as to whether to use debt or equity financing, particularly in management LBO's and other price-sensitive acquisition transactions. However, the interest deduction is only one element of that analysis, primarily affecting only pricing. As indicated above, it is not possible to justify, as a matter of tax policy, a distinction between hostile and friendly acquisitions in respect of the availability of the interest deduction. (See WS at 18–25.)

8. If it were nonetheless decided that a line between friendly and hostile acquisitions might be appropriate for tax purposes, extremely difficult definitional problems would be presented thereby in light of current takeover practices such as "bear hug" offers, "wolf pack" stock accumulations and instances in which an initial offer is initially rejected by independent directors but eventually accepted. The only theoretically valid distinction would be between solicited and unsolicited takeover bids, but such a distinction would likely produce inconsistent results. Accordingly, a distinction based upon voting by independent directors is usually suggested. Any such distinction would not capture all truly hostile bids, and could put very substantial pressure on directors given the predictable tactical consequences thereof (e.g., coercive two-tiered private offers in which the "hostile" price is significantly below the "friendly" price to make up for, among other things, the loss of the deduction). These definitional problems reinforce the basic question as to the viability of any tax distinction between "friendly" and "hostile" acquisitions. (See WS at 16–17.)

9. If it were decided, based upon general debt/equity tax principles, that the deduction should be denied for interest paid on junk bonds, that distinction should apply to all junk bond financings regardless of the particular use of the proceeds thereof. As previously indicated, I do not believe that the tax laws should be based upon acquisition-oriented distinctions. (See WS at 16–17.)

10. I do not believe that a tax incentive for "greenmail" is appropriate for the reasons discussed in WS at 26–27.

11. If the interest deduction were unavailable for junk-bond-financed acquisitions, alternative financing techniques would necessarily become comparatively more attractive, and the overall price of certain transactions might be reduced (because of the impact on IRR's). (See WS at 19–25.) Management LBO's and other extremely price-sensitive transactions would likely be affected more significantly than other types of takeovers. (See WS at 22–23.)

12. See Response 6 above.

[Mr. Keilin did not respond to the request.]

Chairman PICKLE. I keep asking myself, are these companies, after these hostile takeovers occur, are they stronger? Is the stock worth more? Has there been any economic plus or productivity involved other than somebody, the raiders, and the junk bond dealers, or perhaps the investment bankers have made a lot of money off of it? But there is bound to be more to it than those questions. We are not trying to take sides as much as we are trying to understand or trying to find some way to stop this, if indeed it is not productive.

Well, we thank each of you. We know this has been a long haul, but it couldn't be helped. We think we have had some good, valuable information given to us today. We thank you all.

The committee will stand adjourned now. The next meeting at this stage, so far as we know, will be on April 16, on this subject.

The committee stands adjourned.

[Whereupon, at 6:30 p.m., the committee adjourned, to reconvene at 10 a.m., Tuesday, April 16, 1985.]

TAX ASPECTS OF ACQUISITIONS AND MERGERS

TUESDAY, APRIL 16, 1985

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT AND
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The subcommittees met, pursuant to notice, at 10 a.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the Subcommittee on Oversight) and Hon. Charles B. Rangel (chairman of the Subcommittee on Select Revenue Measures) presiding.

Chairman PICKLE. We will ask the subcommittees to please come to order.

Before we begin this morning, let me make another preliminary statement here.

Today we begin our third day of the hearings on the subject of corporate mergers and acquisitions. This hearing is a continuation of the Oversight Subcommittee's ongoing efforts to evaluate the role of the Tax Code in acquisitions and mergers.

When we began these hearings I said that this would be a difficult, technical subject, and our earlier hearings have proven that prediction accurate. Having returned from the Easter recess, hopefully we can now rise to the challenge of bringing clarity to this issue.

We should examine whether these mergers and acquisitions are good or bad for our economy. The answer seems to be that some are and some are not, but with a fair level of disagreement about which are which. I will hope that some of those testifying today would use their experience and expertise to give us a broad, big picture view of where all this takeover activity is leading the American economy. We remain concerned about the level of debt incurred by target corporations who successfully fight off takeovers.

Second, we, as members of the Ways and Means Committee, must determine what role the Tax Code plays in mergers and whether that role is appropriate. A number of witnesses have said that tax considerations do not drive takeovers. But the tax benefits may only be one of many factors taken into account. Others, however, have indicated that the tax laws play a central role in takeovers. I hope we learn today who benefits from the present tax provisions and who loses; the consumer, the shareholder, the Federal Treasury or the national economy. I cannot help but feel that Uncle

Sam's deep pockets have been reached into more than some of us would believe. I think it should be a serious concern.

Third, we must continue to examine when the takeover bid is friendly or hostile. Focus has been on penalizing so-called hostile mergers. It seems to me that distinguishing "hostile" from "friendly" is a difficult proposition for us tax writers. Is this even a valid distinction? We should not lose sight of the broader issues as to whether these mergers are good or bad from the public interest. Are they good economic policy? I look to the witnesses today for some enlightenment. These are tough questions, and I expect no easy answers.

I thank all of our distinguished witnesses for their willingness to be here today and look forward to hearing from you

Before I begin the official testimony of the witnesses, I would ask Chairman Rangel for any remarks that he would care to make on this subject.

Chairman Rangel.

Chairman RANGEL. Thank you, Mr. Chairman.

I want to thank you and the committee members for the interest that has been shown in this rather complex subject matter; and as we move today to conclude these 3 days of hearings that have been held by our joint subcommittee, the record should indicate that we have heard from those corporate people that are required; those who have been the targeted companies, and those who finance and put together these types of transactions.

The witnesses have all indicated that the tax benefits influence the mergers and acquisitions and to what degree these transactions would have made any economic sense without these tax benefits. It is still a concern which the Nation, the Congress and, of course, our committee has. It will be instructive to see if our witnesses today confirm the theme that tax benefits are not the motivating factor; I will be looking forward to any new insights that these issues will provide for us today. Since our select committee will be working on the net operating losses sometime late in this year; even though it is not the purpose of this committee to just change the law, we want to make certain that it makes good tax policy to continue what we are doing and that it is in the Nation's interest.

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Rangel.

Does the ranking minority member, Mr. Schultz, want to make a statement before we begin?

Mr. SCHULZE. Mr. Chairman, you and Chairman Rangel have fairly well set the parameters. It is a complicated subject and one to which we should not jump to any conclusions. It should be a very deliberative process; and that is what we are attempting to make it.

I appreciate the witnesses we have had in the past as well as those who are willing to appear before us today, and look forward to their testimony.

Chairman PICKLE. Thank you, Mr. Schulze.

At the earlier hearing, Congressman James R. Jones was scheduled to testify and could not be here, and has asked the committee permission to present his testimony today.

Mr. Jones, we would be pleased to hear from you at this time, if you will take your position at the witness table.

Mr. Jones, you may proceed as you see fit.

STATEMENT OF HON. JAMES R. JONES, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

Mr. JONES. Thank you very much, Mr. Chairman, and members of the subcommittees.

I appreciate this opportunity and will summarize my testimony and ask that the entire written testimony be included in the record.

Chairman PICKLE. Without objection.

Mr. JONES. I want to dwell on the statement of Chairman Rostenkowski when these hearings were announced. He said, it was important that we have a clear understanding of the importance of the role of various tax provisions of corporate mergers and acquisition procedures, and I would like to rephrase this in two questions.

First, whether the Tax Code currently assists in financing mergers in certain types of merger activity and, if so, what is the effect on the Tax Code in the volume and type of merger activity; and is that harmful? My summation is that the answer to both of those questions is yes. Let me start with the second question of whether or not the Tax Code is harmful in terms of the volume and type of merger activity. I would say, first of all, that the number and method of corporate combinations raises national issues that deserved thoughtful analysis. I do not believe, and I certainly do not stand for the proposition that all mergers are bad. I think it is true that some mergers, including some hostile acquisitions, are good, and that there is ample evidence that most mergers improve market resource, allocation and stimulate effective corporate management. So I do not believe we should unduly interfere with the marketplace. But one does not need to disagree with those individuals who argue that mergers are essentially transactions providing for the redeployment of assets in a manner that realizes greater values for the shareholders in order to argue that there are valid reasons to be concerned about certain limited types of merger activities or to be concerned that there is a danger in liquidation, two tiered takeover methods.

I believe these takeover tactics are an abuse of the free market process, and a legitimate matter for congressional concern. Let me explain why.

First of all, liquidation mergers, in my judqment, are creating too much corporate debt. The corporate debt that is being created makes the Federal Government look like Boy Scouts During the first 2 days of testimony you heard comments on what raiders look for in potential targets, and one of the major factors raiders take into consideration in identifying a target is whether the corporation is under levereged. This means that the corporation is not an attractive target if its financial statement is replete with a debt laden balance sheet. I guess, moreover, this is also what the Council of Economic Advisers means when it says that takeovers help recapitalize firms where their financial structures are more in line with prevailing market conditions.

What Congress is being told by these raiders and others is a corporation which takes steps, even risky ones, to eliminate virtually all of its corporate tax liability is to be commended. On the other hand, firms that take risk by financing with equity capital should be considered inefficient management.

Our latest case study; namely, Phillips Petroleum, shows what good raiding tactics accomplish. The company has rewritten its financial report with a sheet that increased debt from 23 percent total capital to 81 percent. It is difficult to believe that this situation has created a company more able to face future investment events and that it will be more vigorous in replacing depleted oil reserves.

Now, strong arguments can be made that the drastic increase in debt from financing from corporate takeovers is overleveraging corporate America. Moreover, there is a legitimate concern as to whether they will continue to be able to service this heavy debt burden. Most takeovers have added this debt to balance sheets at a time when the economy is growing; and the question I think we have to ask is: What happens in the next recession?

I think the Federal Reserve Board has already cautioned the financial institutes about this; and you will be hearing from them today.

A second concern is that liquidating mergers impairs long-term growth and planning. I think this is one of the major deficiencies that American management has in relation to our industrial competitors overseas, particularly from Japan and German. They have much more of a longer view toward management decisions toward penetrating markets.

One of the things that we are finding with the hostile takeover activity is that corporate Board rooms are thinking much more short term. I think that is bad for competitiveness in the future.

A third item, liquidation mergers have not installed better corporate management. Few practitioners would disagree with the proposition that the hostile takeover bidder now holds most of the cards in takeover contests, nor would many disagree with the premise that liquidation raiders have little in mind but to make a fast buck. Their real motive is not better management, as some have argued, but it is big money. In fact, most credible evidence suggests that the acquirers have no better management than the targeted company.

A study discussed in testmiony before the Energy and Commerce Committee conducted by the Columbia School of Law found that to be the case. The study lead one witness to conclude that there is no basis to the argument that mergers on the average replace lackluster or inefficient management. In fact, we might take a look at one specific example, and that is that it is in the news now, the attempt of Mesa and Boone Pickens to take over Union Oil Co.

For example, between 1980 and 1983, Mesa return on exploration and development assets averaged 13.25 percent and during that same period, Union experienced an average return of 34.25 percent. Furthermore, during the 1982 to 1984 timeframe, Mesa experienced an average finding cost per barrel of oil of $12.08, and that compares to Union's average finding cost per barrel of $8.30, a remarkably better price than Mesa's.

In terms of long-term planning, another measurement of good management, between 1980 and 1984, Mesa spent no money on research and development. Union, during the same 4-year period, spent over $45 million. So it appears that raiders claim that they are seeking to replaced entrenched, inefficient management may be referring to their own companies' management.

Another item, liquidation breakups insure destruction of healthy corporations. I think the most recent data indicated that the average market value of traded stock, in proportion to the average replacement cost of assets reflected by such stock is 0.654 to 1. The ratio, however, of average acquisition cost of a corporation to its overall replacement cost is 0.98 to 1. It is argued that an acquirer could pay 50 percent above the previous stock market price and still buy the average firm for less than its replacement cost. Why is this important?

Well, the debate as to why the stock market values corporations well below the replacement cost to their assets is, of course, best left to the Nation's economists, and there you will get a variety of opinions; but my reasons for mentioning this is simply to illustrate the ramificiations of our policies. If raiders are willing to bid up prices and tender offers near the replacement cost of the assets held by the target entity, this assures that the target's ongoing corporate activity must be substantially if not entirely curtailed. And this is evidenced by the fact that the stock market is not willing to sustain a share price level that even closely approximates the replacement purchasing cost threshold. So we are assured of eventual liquidation. So it seems appropriate for Congress to ask itself whether the Federal Government should be a silent partner in such an activity. To me the answer is that the Government should get out of the role of underwriting these liquidation takeovers through our Tax Code.

Now, the role of the Internal Revenue Code on and breakup liquidation takeovers, I think, is very significant. What our legislation does is to basically get the Government out of the business of participating in liquidation acquisitions without hindering the legitimate movements of capital necessary in our free market system. The bill, H.R. 1100, has about 60 cosponsors, including several members of the Ways and Means Committee. Without going into great detail, it is designed to take the incentive out of green mail operations and to put somewhat of a cold shower on the financing of hostile takeovers through junk bonds. That is the basic premise of it. It stems from previous actions of this Congress in 1969. It comes from some of the testimony that we have received as to whether or not green mail is a good practice; and I think that is uniformly condemned. Second, it concerns whether the Tax Code should foster the financing of hostile takeovers through junk bonds.

Let me just conclude by restating what our inquiry means for corporate America. There are two questions.

Contrary to vociferous allegations, our inquiry does not mean that we believe that all mergers are implicitly bad, nor does action on our part indicate that we are seeking to protect incumbent management. Should we conclude that specific legislative proposals are appropriate, that does not mean that we intend to discourage merg-

ers and, most importantly, it is helpful to keep in mind that it is not necessary to conclude mergers are primarily motiviated by the Tax Code provisions in order to justify remedial actions under our tax laws.

Whether mergers are good or bad, it seems to me that it is time for the U.S. Treasury to stop footing the bill for one-half the cost of those mergers; and that is why I hope that this committee will recommend action action, something similar to H.R. 1100.

Mr. Chairman, I appreciate the chance to share these comments with the committee.

[The prepared statement follows:]

STATEMENT OF HON. JAMES R. JONES, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

The Subcommittees today focus on corporate combinations and corporate acquisitions. I am very pleased to be here to discuss some of the more significant Federal income tax provisions which influence decisions on corporate changes of ownership.

I asked to appear before you today, although I earlier submitted a written statement for the record, because I feel it is important to bring into focus what we hope to accomplish from our inquiry. Our purpose is really quite simple.

As Chairman Rostenkowski stated when he announced the hearing, our inquiry is being scheduled because, "It is important that we have a clear understanding of the importance and role of various tax provisions in corporate mergers and acquisition decisions." Perhaps, this can be summarized in two questions: (1) Whether the tax code currently assists in financing mergers and certain types of merger tactics; and (2) if the effect of the tax Code on the volume and type of merger activity is harmful.

My premise is that both of the questions must be answered in the affirmative. My testimony will consider them in reverse order.

I. THE NUMBER AND METHOD OF CORPORATE COMBINATIONS RAISE NATIONAL ISSUES THAT DESERVE THOUGHTFUL ANALYSIS

Let me begin by stating my bias on the issue of whether corporate combinations are harmful. There is no justification to the claim that all mergers are bad. It is also true that some, in fact many, hostile acquisitions are good. There is ample evidence that most mergers improve market resource allocation and stimulate effective corporate management. Therefore, we should not seek to interfere with or prevent legitimate economic activity that is a natural process in a healthy, growing economy. We should not restrict investors' and company managers' ability to merge capital. Nor should we discard shareholder rights to replace lackluster management.

On these points I agree with most of the investment community who have testified to you.

But one does not need to disagree with those individuals who argue that mergers are essentially transactions involving the redeployment of assets in a manner that realizes greater values for the shareholders,[1] in order to argue that there are valid reasons to be concerned about certain, limited types of merger tactics; or, to be concerned that there is a danger in liquidation, two-tiered takeover methods. I believe these takeover tactics are an abuse of the free market process, and a matter for Congressional concern. Let me explain why.

A. Liquidation mergers are creating too much corporate debt

During the first two days of testimony you heard comments on what raiders look for in potential targets. One of the major factors raiders select in identifying potential targets is whether a corporation is under-leveraged.

This means, presumably, a corporation is not an attractive target if its financial statement is replete with a debt-laden balance sheet. Somehow, the raiders would have us believe that such debt-heavy corporations represent what they consider "effective corporate management." I guess, moreover, this is also what the Council of

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[1] *See generally,* Hearings Before House Ways and Means Subcommittees on Oversight and Select Revenue Measures, 99th Congress, 1st Sess (April 2, 1985) (Testimony of Eric J. Gleacher).

Economic Advisors means when it says takeovers "help recapitalize firms so that their financial structures are more in line with prevailing market conditions." [2]

What Congress is being told, in other words, is that the corporation which takes steps, albeit risky ones, to eliminate virtually all of its corporate tax liability is to be commended. On the other hand, the firm that takes measures conducive to long-term growth and risk taking by properly capitalizing its financial structure with equity capital, should be considered ineffective management.

Our latest case study, Phillips Petroleum, shows what good liquidation raiding tactics accomplish. The company has rewritten its financial report with a balance sheet that increased debt from 23 percent of total capital to 81 percent. It is difficult to believe that situation has created a company more able to face future investment demands, and that it will be more vigorous in replacing depleting oil reserves.

Strong arguments can be made that the drastic increase in debt-financing from corporate takeovers is over-leveraging corporate America.[3] Moreover, there is legitimate concern as to whether they will continue to be able to service this heavy debt burden. Most takeovers have added this debt to balance sheets at a time when the economy is growing. What will happen once we enter the next recession? The Federal Reserve Board has already cautioned financial institutions about this concern. Let me encourage you to probe this question further with them today.

B. Liquidating mergers impair long-term growth and planning

When companies struggle to avoid becoming targets, by pushing share prices upward and making quarterly reports look better, management's focus is only on short-term results. The first thing they forget about is tomorrow.

One leading tax expert put it this way: "One can analogize the situation to a farmer who does not rotate his crops, does not periodically let his land lie fallow, does not fertililze his land and does not protect his land by planting cover and creating windbreaks. In the early years, he will maximize his return from the land. It is a very profitable short-term use. But invariably it leads to a dust bowl and economic disaster."

We are forgetting to plant the seeds that produce long-term growth and prosperity. Tomorrow our corporate assets will be dismembered. This myopic vision in corporate planning is something we are ill-prepared to sustain.

At a time when we are calling upon the Congress to enact protectionist measures against our Japanese trading partners, it makes little sense to ignore the domestic policies which influence our battle to compete in international markets. There will be no war for the telecommunications market if we forego long-term research and development.

C. Liquidation mergers have not installed better corporate management

Few practioners would disagree with the proposition that the hostile takeover bidder now holds most of the cards in takeover contests.[4] Nor would many disagree with the premise that liquidation raiders have little in mind but to make a fast buck. Their real motive is not better management; it's big money.

In fact, most credible evidence suggests that acquirers have no better management than the targets. A study discussed in testimony before the Energy and Commerce Committee, conducted at the Columbia School of Law found that, "the industrial company targets of hostile takeovers in 1981 had an average return on equity over a full four year period of 16 percent. Yet only once in the past decade has the return for all manufacturing corporations been above 15 percent." [5] This study led that witness to conclude: there is no basis to the argument that mergers, on the average, replace lackluster or inefficient management.

Let's also look at a specific example currently in the news: the Mesa raid on Union Oil Company. I would suggest there is no evidence that Mesa has been a better run oil company than Union. For example, between 1980 and 1983, Mesa's return on exploration and development assets averaged 13.25 percent. During the same period, Union experienced an average return of 34.25 percent. Furthermore, during 1980 through 1984, Mesa experienced an average finding cost per barrel of oil of $12.08. Union, on the other hand, had an average finding cost per barrel of $8.30, remarkably better than Mesa's. What about long-term planning? Between

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[2] See, e.g., *Economic Report of the President*, pg. 196 (1985) ("President's Report")

[3] *See generally*, Remarks of Robert A. Profusek, Testimony to Ways and Means Subcommittees on Oversight and Select Revenue Measures, 99th Congress, 1st Session, (April 2, 1985) pg. 21

[4] *Id.* at pg. 6

[5] *See generally*, Hearings Before House Committee on Energy & Commerce, 99th Congress, 1st Session (Testimony of Warren A. Law, Harvard Business School, Professor of Finance) (March 12, 1985)

1980 and 1984, Mesa spent *no money* on research and development. Union, during those four years, spent over $45.4 million. It appears the raiders claim that they are seeking to replace entrenched management, may be referring to their own company's management.

D. Liquidation breakups based on replacement cost prices insure destruction of healthy corporate operations

The most recent data available indicate that the average market value of traded stock in proportion to the average replacement costs of assets reflected by such stock is .654 to 1. The ratio, however, of average acquisition costs of a corporation to its overall replacement costs is .98 to 1.

It is argued, therefore, that an acquirer could pay 50 percent above the previous stock market price and still buy the average firm for less than its replacement costs.[6] Why is this important?

The debate as to why the stock market values corporations well below the replacement cost of their assets is best left to the nation's economists. My reason for mentioning this fact today is simply to illustrate the ramification of our policies.

If raiders are willing to bid up prices in tender offers near the replacement cost price of the assets held by the target entity, this assures that the target's ongoing corporate activity must be substantially, if not entirely, curtailed. This is evidenced by the fact that the stock market is not willing to sustain a share price level that even closely approximates the replacement, purchasing cost threshold. We are assured of eventual liquidation.

It seems appropriate, therefore, for Congress to ask itself whether the federal government should be a silent partner in such activity. To me the answer is that we should keep the federal government out of the role of underwriting these liquidation takeovers.

II. THE ROLE OF THE INTERNAL REVENUE CODE IN BREAKUP LIQUIDATION TAKEOVERS

The current tax system is a significant factor in the wave of breakup liquidation takeovers. My legislation has one simple purpose: to get the government out of the business of participating in liquidation acquisitions without hindering the legitimate movements of capital that are necessary in our free market system. My bill, H.R. 1100, legislation with over sixty cosponsors, including Mr. Matsui, Mr. Stark, Mrs. Kennelly, Mr. Dorgan, Mr. Gibbons, Mr. Pease, and Mr. Jenkins, has gained bipartisan support among members.

First, my legislation would end the universally condemned practice of greenmail. Greenmail, as you know, is the speculator's version of blackmail. It occurs when a speculator buys up a large block of shares in a publicly-traded company, with no purpose beyond threatening the corporation into buying back the shares at a premimum. The provision in H. R. 1100 is mirrored after what the Committee enacted on golden parachutes during the 1984 Tax Reform Act.

Second, my legislation would reduce the interest deduction that is now allowed for indebtedness incurred in corporate acquisition. The current tax code already restricts deductions for this purpose; my bill would increase this restriction by denying the deduction when a takeover is funded by junior obligation debt–known in the trade as "junk bonds."

Why am I concerned about junk bonds? To answer accurately this question it is necessary to review the legislative history behind two provisions in the Code, 279 and 385.

Where to draw the line between corporate equity and corporate debt is a question Congress has pondered for a number of years without adequate resolution. The manner in which we resolve the distinction is very important in a tax structure that allows interest paid on debt to be deductible, but dividends paid to shareholders on equity are not. As long as we have a system of double taxation of corporate profits, the distinction between equity and debt will be of great importance. Allowing corporate entitities to treat certain investment as debt rewards them with great tax savings.

Today, when we are witnessing a wholesale restructuring of corporate balance sheets, the potential for wiping out most corporate tax liability is very real. As debt replaces equity, that means that approximately one half of the burden of financing corporate ownership is put upon the Federal Government.

That is the reason, in 1969, Sections 279 and 385 were added to the Code, in large part to reduce tax incentives for then-prevalent corporate merger activity. 385 gives

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[6] Id. *See generally.*

the U. S. Treasury the authority to promulgate regulations on how to distinguish between debt and equity. However, after a delay of ten years, the regulations that were promulgated in 1980, were far from satisfactory. The final regulations were withdrawn, leaving us today with prior case law, and few published rulings to guide the Service in judging between debt and equity.

Section 279 imposed limitations on the ability of an acquiring firm to issue subordinated convertible bonds that allowed the acquirer to pay for the acquisition through the interest deduction. Since a debt instrument must satisfy a number of statutory safe harbors before the interest is disallowed, however, today 279 is easily avoided. Therefore, it is time to make these current provisions of the Code more workable in light of today's sophisticated investment practices.

My bill would treat junk bonds as equity when certain tests are met. The reason for taking this step is that when corporate mergers are financed with junk bonds the distinction between equity and debt completely blurs. Left unchecked, conventional equity ownership would disappear. And, what this means for our tax system is that these transactions have the potential of wiping out the corporate income tax liability of companies subject to such raids. If we want to adopt a system of corporate tax integration, we should simply leave unfettered the practice of financing corporate acquisitions with junk bond financing.

These two areas are provisions I feel the Committee should act upon immediately, without waiting for the long-term Subchapter C project which is under consideration. We cannot afford to wait for the utopia of tax reform in the area of Subchapter C. Even all of the major tax reform proposals fail to address the problems replete through Subchapter C.

In conclusion, let me restate what our inquiry means for corporate America. Our inquiry, contrary to vociferous allegations, does not mean that we believe all mergers are implicitly bad. Nor does action on our part indicate that we are seeking to protect incumbent management. Should we conclude that specific legislative proposals are appropriate, that does not mean we intend to discourage mergers. Most importantly, it is helpful to keep in mind, that it is not necessary to conclude mergers are primarily motivated by tax Code provisions in order to justify remedial actions under our tax laws.

Whether mergers are good or bad, it is time the U. S. Treasury stop footing the bill for half the cost. That is what I am attempting to accomplish through H.R. 1100.

Chairman PICKLE. Thank you, Mr. Jones. We appreciate your statement and your interest in this problem, as well as the legislation that you have introduced.

We will now go to the questioning of the witness, if any members care to; and I would ask each member to limit their questioning to the 5-minute period, if possible.

Let me ask you, then, Mr. Jones, two or three questions.

No. 1, your bill would provide for a 50-percent-excise tax on greenmail.

What do you call greenmail? Do you have a definition of greenmail?

Mr. JONES. Well, greenmail is a dressed-up term for corporate blackmail. That is where a significant shareholder is able to extract out of a corporation a premium payment for the stock in order to prevent further hostile takeover activities. I think that we can come up with a precise definition of greenmail, a legal definition; but that is basically my intent.

Chairman PICKLE. Does your legislation define what is greenmail? Do you attempt to do that in your legislation?

Mr. JONES. I will read you the definition we have in the bill.

Chairman PICKLE. In the meantime, let me ask you, why do you go the excise route rather than some other approach?

Mr. JONES. Well, we have gone the excise route in the past to discourage certain things; and basically we were just trying to take the profit motive out of greenmail operations.

Chairman PICKLE. Could you use a 100-percent figure?

Mr. JONES. If you are taxing capital gains at the maximum, that would be roughly 20 percent; add 50 percent, and you have got a 70-percent tax. That takes a good deal of the profit motive out of greenmail operations.

Mr. Chairman, on our bill, the green mail profits are defined in page 2. It is any gain realized by a 4-percent shareholder on the sale or exchange of any stock in the corporation if such shareholder held such stock for a period of less than 2 years; and if at some time during the 2-year period ending on the date of such sale or exchange there was a public tender offer for such stock in the corporation, or a 4-percent shareholder submitted a tender offer setting forth a plan that involved such a public tender offer——

Chairman PICKLE. We will look at that definition because it bothers us as to how to define greenmail.

Two weeks ago, Mr. Pickens said he did not accept any greenmail.

Mr. JONES. I think that is questionable. Mr. Pickens got a preferential offer.

Chairman PICKLE. He denied it. He said he did not.

Mr. JONES. Mr. Pickens made some other statements that I think could be corrected once they are looked at in the record.

Chairman PICKLE. Would you care to mention any of them, or just in general?

Mr. JONES. I think one that you just brought up, the same offer of cash for stock that Phillips made to Mr. Pickens was not made to all shareholders, and there clearly was a preferential offer in the Phillips things to Mr. Pickens.

Chairman PICKLE. We will look into that.

Now, your legislation, I understood, would deny the deductibility interest for debt incurred in a hostile takeover.

Now, I ask you in drafting your legislation that would deny the deductibility of interest, was consideration also given to denying the deductibility of greenmail payments by the corporation making the payments?

Mr. JONES. I think it should be, yes.

Chairman PICKLE. Now, Treasury said it would not allow the corporate entity to deduct the interest; and if that is so, would you consider amending your legislation to provide for that?

Mr. JONES. Yes; I think that would be a good amendment to the legislation. As I understand it, the courts have spoke in two opposite opinions on this particular issue, and I think it should be made clear that the corporation should not be allowed to deduct it.

Chairman PICKLE. The Chair recognizes Mr. Rangel for any questions he might have.

Chairman RANGEL. Thank you, Mr. Chairman.

Mr. Chairman, there has been much speculation as to the motivation of those who target these corporations. It has been vague as to just how much the tax benefit has been the primary motivation. Have you given any thought to allowing the Securities and Exchange Commission the authority to determine abuse, as it relates to the purchase and sale of stocks, rather than having our committee try to determine whether it was a tax motivation, even though most everyone denies that it was just a small factor?

Mr. JONES. I would think that the Securities and Exchange Commission, that the FTC and any other appropriate agency should look into this. I frankly do not have much confidence that those agencies look upon merger activity in any form as being detrimental to a free market system, so I do not think anything is going to come out of that.

This committee and the Congress has looked upon mergers before, in 1969, and determined that there were some tax incentives that should be taken out of mergers. I think that is an appropriate answer in dealing with these hostile takeovers and greenmail activity; and that is why I think this committee should look at it.

Chairman RANGEL. The staff has given me a report indicating that out of the Fortune 500—I do not know if I have it here, but somebody may have it in the back—that there are very few of the mergers—a study done by McKinsey & Co., for the securities industry. This study indicates that 82 percent of the 1967 to 1982 growth companies were internally generated; and only 18 were attributed to mergers.

Do you think——

Mr. JONES. I am sorry? 82 percent were——

Chairman RANGEL. Internally generated; that is, they were involved in mergers—the companies involved with mergers started it. There was no friendly hostile raiders coming in doing this thing in order to take advantage of the Tax Code. In other words, what they are saying is, 82 percent of it was the normal marketplace working its will and it worked out.

What we have been afraid of is throwing the baby out with the bath water. If some people have found a loophole, we want to close it. By the same token, if this is true, that 82 percent of the mergers have been internally generated as opposed to raiders and unfriendly ripoff artists coming in, would you not be concerned that an amendment to the law, to penalize those wrongdoers, would who have taken advantage of a situation which might not adversely affect the normal health and growth of acquisitions and mergers?

Mr. JONES. This is one of the things that I was very concerned about in drawing up the legislation.

When we threw the net out, we wanted to catch the few bad fish and not all the fish in the lake; and that is why we drew the legislation very tightly.

For example, it pertains to only hostile takeovers. The best definition we could find of a hostile takeover came out of the Judiciary Committee which said a majority of the outside directors would determine whether or not this was a takeover, it was hostile; and in the best interests of the company. Therefore the 82 percent you suggest would not ever be affected by this legislation. But I think as you look at the bad fish in this corporate raider activity, I think it is fair to say that the weight of evidence is very much against this as good public policy, and even in the best interests of a free-enterprise system; and that is the kind of thing we are trying to get at. We are trying to take the tax incentives out of that kind of transaction. I believe the legislation is tightly drawn and I am not worried about catching that 82 percent with this legislation.

Chairman RANGEL. I would ask you to take a look at the testimony of Mr. Pickens. After the Oklahoma delegation testified, I thought someone was coming in here with horns, and apologetic, and say that is the way the law of the jungle works, but he was a very, very impressive witness; and he had indicated that he was only working in the free market and that we could do whatever we wanted to do, but he did not have any problems at all; that he would continue to do what he was doing; and it was in the best interests of the U.S. economy.

I hope that you and the staff of the other members from Oklahoma might analyze that testimony, because it was diametrically opposed to what we heard one day and his presentation the next.

Mr. JONES. No question, he was a very impressive witness.

One of the things we would appreciate is to take his testimony, analyze it, make our own critique, because there are things in there that should be corrected for the record. We are more sensitive to this because in Oklahoma we have been the hind leg of several hostile corporate mergers and it has ended up leaving the basic stockholders, the employees and communities poorer for it.

Chairman PICKLE. Mr. Jones, you have made a clear indication that Mr. Pickens made some incorrect statements, and we want you to substantiate that further with us, if you care to. It has been said that he did receive preferential treatment; that he was given cash for his stock instead of stock for stock.

Mr. JONES. That is right.

Chairman PICKLE. And he said that stock and the cash are one and the same thing. The fact was that he was given preferential treatment, you say, by getting cash for his stock, and that was not made available to all the other shareholders, although in theory perhaps it was, and the company has said they did give him preferential treatment, so there is a conflict in what he says and what the company has said, as I understand it.

Is that your understanding of the analysis?

Mr. JONES. What is the last sentence? I got up to the last sentence.

Chairman PICKLE. Mr. Pickens has said that he did not receive preferential treatment. My analysis is that he did receive preferential treatment, and the company said he received preferential treatment, and there is a conflict, then, between what Mr. Pickens said and what the company said; and it is up to someone to determine who is making the correct statement.

Mr. JONES. What we would like to do is take his testimony and give our critique of it in a number of different respects, this being one of them; and we would submit that for the record.

Chairman PICKLE. We would like to have you submit that for the record; and we will extend the same courtesy to Mr. Pickens, too.

Mr. SCHULZE. Thank you, Mr. Chairman.

We step back and look at tax law and how we should deal with it. Why should we differentiate between a hostile or a friendly merger or takeover?

Mr. JONES. Basically, I think you have to look as we have in the past——

Mr. Schulze. Just from a tax law point of view.

Mr. JONES. Well, the first question that has to be asked is whether or not these hostile takeovers are good public policy, and it has to be looked at from the broad perspective of corporate America——

Mr. SCHULZE. But would you not say whether takeovers and mergers in general are good——

Mr. JONES. That is a threshold question.

Mr. SCHULZE. It is very difficult for me to differentiate.

Mr. JONES On the basis that mergers per se are not bad, the question is, is this kind of corporate raider activity an aberration; is this something that should be singled out, and in my judgment, the weight of the evidence is that it should. The question is, therefore, how do you go about doing it?

Do you flat put a moratorium or regulate against it? I think that is an undue interference in the marketplace. When you ask what is prompting this kind of activity; in my judgment, considerable evidence is that the Tax Code is prompting this kind of activity. So I think then you go at the source and say, let us try to take that tax incentive out that is the correct approach that is why we are approaching it from this angle.

Mr. SCHULZE. With Oklahoma having been impacted or potentially impacted, why would it not be better to deal with this through State law?

Mr. JONES. There is no way you can deal with it through State law. This is interstate commerce, and those State jurisdictions that tried to get involved clearly did not have the jurisdiction to deal with it.

Mr. SCHULZE. You could not pass a State law that would address an acquisition where the corporate headquarters are——

Mr. JONES. Yes. It is conceivable that that could be done, depending on how it is worded, it may or may not withstand the judicial test.

Mr. SCHULZE. Jim, in your legislation where you say the independent directors hold the key to whether it is a friendly or a hostile takeover really gives me great pause. I can see many situations where you might—where the independent directors might be relatively evenly divided where you have one or two individuals whose vote is going to mean millions or billions of dollars. There are all kinds of opportunity there for hanky-panky which concerns me greatly. I just am not at all happy with that definition.

Mr. JONES. Let me say I am open to any suggestion on how to define this. We searched around for the best way to measure hostile takeover activity and felt that this was the best. This was something that I believe the Judiciary Committee has come up with.

The reason we think it is the best definition is because there is a much different responsibility on directors now than there was just a few years ago. I think outside directors take that independent responsibility very seriously, and they are looking at the corporate constituency, shareholders, employees, community, et cetera. I think you are likely to get what is in the best interests of the corporation a serious review by the outside directors.

Mr. SCHULZE. You do not think it would lead to the demise of the truly independent outside director?

Mr. JONES. It would strengthen it.

Mr. SCHULZE. If I were chairman of the board of a corporation, under this legislation, I would make sure that the directors coming on my board would do what I told them.

If this were in the legislation, I guarantee you that my attorney and his brother-in-law and everybody else that I would have some major influence or control over would be on that board. I think it would weaken the corporate structure rather than strengthen it. And you tell me that you would not, if you were the chairman of the board——

Mr. JONES. I would say if I was the brother-in-law of the chairman and I was the outside director, I would strengthen my outside independence, knowing that the law suits would come at me individually.

Mr. SCHULZE. I cannot see that happening.

Chairman PICKLE. Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

Jim, I want to commend you for putting the effort into this that you have, and working in what you certainly consider to be the best interests of the stockholders and the employees of these firms and trying to deal with this problem in every way. I commend you for it.

I have a point or two that continues to bother me in your proposal.

In those situations, as I understand your legislation would only come into play when there is a, quote, hostile, takeover, close quotes. If a corporation today, without there being any attempt to take over, can go borrow money and acquire some of its own stock; and depending on what the interest rate and the other economic aspects are, can in fact increase their market price of the remaining stock. And in those cases, you wouldn't deny, even if they used junk bonds, you would not deny——

Mr. JONES. That is correct.

Again, I think this is something that the committee has to look at and constantly oversee, to see if there is not an abuse of the system. I have no evidence that there is an abuse of the system under that practice now.

Mr. FLIPPO. But essentially the only thing that would be different about a hostile takeover would be two things, as I understand it. If it is a hostile takeover the same transaction can occur and, in that case, you would have your bill come into play.

Mr. JONES. That is correct.

Mr. FLIPPO. And deny the interest deduction. And so it seems to me that what has taken place is that in a hostile takeover perhaps you have different management, perhaps you do not. I guess the acquirers of the corporation could leave the existing management in there if they so desired. It just seems like to me that it is very, very difficult to distinguish the difference and to be able to define in law what constitutes a hostile takeover; and I am aware of the definition that you are using in the Judiciary Committee and it just concerns me that I am certain that that may not be a situation that may lend itself to very much administration and definition.

Mr. JONES. Well, I appreciate that. The concern I had is that we try to define tightly where we felt the abuses were, and to deal

with that. We did not find abuses in the areas other than the hostile takeover with junk bonds.

Mr. FLIPPO. Well, I wanted to commend the gentleman again for his great effort in this area; and thank you for your testimony.

Chairman PICKLE. Mr. Frenzel?

Mr. FRENZEL. Thank you, Mr. Chairman.

I do want to compliment our colleague for the work he has done on this and like other members, express a little concern that I have.

The definition of "hostile takeover" bothers me a little bit, too and, as a matter of fact, I am not so sure that a hostile takeover is a bad thing. I think what maybe we ought to do is try to make sure that the stockholders get treated reasonably, fairly, and equally. There are in all probability, management anxious not to lose their private little playpen, who have been taken over and who richly deserved to be taken over on a very hostile basis. In many of these cases the stockholders were rewarded.

So I guess the whole concept of whether it is hostile or not does not seem to me where the focus should lie. I must confess to not really knowing how to approach the problem.

Mr. JONES. Would we agree that a two-tier approach is bad, where stockholders are treated differently?

Mr. FRENZEL. Yes.

Mr. JONES. I certainly cannot defend all management, including throughout the oil industry. There is some entranched inefficient management. I think the studies show that in some cases it is a close call as to whether a hostile takeover is good or bad, but I think the weight of the evidence is that it has not been good for that broad constituency of corporate America; but I recognize your concern and it clearly is one that I had.

Mr. FRENZEL. Well, I used to work for a company in which other companies were acquired. Sometimes my company's acquisitions did not work out very well for our stockholders, either. The result was not our intention, but it happened. I am nervous about outside directors, too. I do not really know what an outside director is. I do not know how to define one.

If he is my brother-in-law, I would like him on my board. He might not be assocated with the company, but I am not sure he is an outside director. I think there are a lot of companies that do not like outside directors. In fact, I believe one of the prominent oil companies has not had them over the years.

When Mr. Pickens was giving testimony, he suggested that the best way to handle greenmail was simply to demand that all offers applied to all stockholders. Is that responsible, in your judgment?

Mr. JONES. Yes. That is one approach to it. And on the surface, without thinking it through, it sounds very good, because essentially that is what we are trying to get at through the tax approach.

Chairman PICKLE. Would the gentleman yield?

Mr. FRENZEL. I yield.

Chairman Pickle. That is the point I was trying to pursue a minute ago, in the case of Mr. Pickens. We are not trying to pick on Mr. Pickens, but he is a good example for us to be analyzing here at this particular time. He was offered cash for his stock. All of the stockholders were not offered cash. The others were offered

stock for stock, so to that extent, he was offered preferential treatment, it seems to me, and to that extent, the stockholders were not all treated the same.

That, now, can be argued, and I am sure that was Mr. Pickens' argument, that the stockholders were all treated the same as he was, but the actual development was that when this transaction did take place, as I understand it, the stock went down. Phillips was heavily laden with debt, and Mr. Pickens had his cash, but the stockholders had less value.

Now, if that was the development, it was something that we have to give consideration to.

I thank the gentleman for yielding.

Mr. FRENZEL. Did you use this greenmail approach simply because it was our jurisdiction?

Mr. JONES. Well, not really. Again, we looked at the question, can you regulate against these kinds of practices; namely, greenmail, and the hostile takeover? And the more I looked at it from a regulatory point of view, I could not find a way to do it without undue interference in the marketplace, and the free flow of capital. The more we talked about it, the more we probed into it, it seemed that the tax approach was the preferable way to do it. That is the way we did it.

Mr. FRENZEL. I do not know about this 4-percent taxpayer. The other way seemed a little more direct to me.

Mr. JONES. I would like to explore that. It sounds good and simple.

One of the things that both of us have found in the Ways and Means Committee and the Budget Committee are the things that are simple and sound good often do not work.

Mr. FRENZEL. I understand.

Chairman PICKLE. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

And welcome, Jim.

I am concerned also, and have some fears about the definitions of "hostile" versus "friendly," and, of course, the treatment of different companies as it applies to divestability of interest; but on a policy ground, why do you think it is proper for a vote of independent board members to be so much more than the determination of perhaps the Congress or the Department of the Treasury, or the SEC?

Mr. JONES. I am not trying to interfere in the free market system. We are trying to figure out how you can define what is a good practice and what is bad for a free-enterprise system. Inside directors have a stake in management, so they are going to be very biased and controlled. With the new emphasis on outside directors and their responsbilities and the legal liabilities to which they are held, we thought that would be an appropriate independent view of what is best for the entire corporate constituency.

As I said, I am open to another approach, but this was the best approach we could find in probing the question.

As far as the Justice Department and others are concerned, frankly, if we can do it without the Government making that determination and keeping it as much inside the freemarket system, the better, in my judgment.

Mr. McGRATH. My only concern is that we may be treating different entities very much differently when it comes to the use of that deduction and it worries me to some extent.

Thank you, Mr. Chairman.

Thank you, Jim.

Chairman PICKLE. Thank you, Mr. McGrath. I appreciate your statement and your testimony, Mr. Jones.

[The following was submitted for the record:]

STATEMENT OF HON. DON BONKER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WASHINGTON

Mr. Chairman and Members of the Committee, I am grateful for the opportunity to testify today on the issue of corporate mergers and acquisitions.

I cannot claim to be an expert on the intricacies of corporate takeovers or the tax and regulatory policy affecting mergers and acquisitions. I know that your Committee is now well into the third day of exhaustive hearings on all aspects of this issue, so my remarks will be brief.

My primary purpose in testifying this afternoon is to express my concern over the current trend in corporate mergers, particularly hostile takeovers. I also want to express my general support for H.R. 1100, legislation introduced by Mr. Jones and several of our colleagues to curb the excessive use of "greenmail," "junk bonds," and other methods associated with hostile corporate takeovers.

I believe the aims of H.R. 1100 are sound. The bill is designed to end our government's participation in fostering or financing hostile takeover attempts through the tax code. Specifically, H.R. 1100 would levy a 50 percent excise tax on all "greenmail" profits gained by a major shareholder in return for not attempting a takeover. The bill would also eliminate the tax deduction for interest paid on bonds issued to generate capital for hostile takeover attempts.

I know that Mr. Jones testified before this panel earlier today, and that Committee members raised a number of questions about how the proposal would actually work. I can understand that provisions of the bill may need to be strengthened or revised, particularly in the area of defining "greenmail," what constitutes a "hostile acquisition," or whether other approaches may be more equitable.

I do want to commend Mr. Jones for his leadership in drafting this bill, and express my support for its general principles and goals. I hope the Committee will be able to move ahead quickly in considering the legislation and strengthening its provisions if necessary.

As a number of people have pointed out in the course of these hearings, corporate and mergers are not necessarily a bad thing. Under the best of circumstances, the free marketplace uses mergers and takeovers to better allocate capital, resources, and management.

The negative side of mergers has become increasingly apparent, however. In many cases, the aim of a takeover is short-term profit or speculative gain. Attempted takeovers can take on the form of corporate extortion, generating lucrative payoffs for the corporate raider, but bleeding an otherwise productive firm white. These are not positive by-products of the free market, and our government should not be countenancing or fostering these types of activities.

I would like to share with the Committee one example which hits close to home in my Southwest Washington District. Crown Zellerbach, the San Francisco-based timber giant, operates a large paper plant in Camas Washington, on the Columbia River. The mill employs over 2,000 men and women, and each year generates $5,661,000 in state, county, and city taxes.

As the members of the Committee know, Crown Zellerbach is currently the object of a hostile takeover bid by Sir James Goldsmith, a European investor whose group owns roughly 8.6 percent of Crown Z's stock. Here is how the largest daily newspaper in my District views the situation:

"[Goldsmith] doesn't pretend he wants the big company in order to continue its record as a fundamental part of Camas and a good citizen of Clark County. He wants its undervalued assets in forest land and other resources. He expects to wring bigger profits out of the company by tougher management based on short-term gain rather than long-term corporate responsibility and survival. He can hardly lose. If he does not win control of the company, he stands to harvest a huge profit from selling his shares at the end of the raid."

As the resident Congressman, I am deeply disturbed at the potential outcome of this serious situation. If Goldsmith succeeds in gaining control of Crown Z, he will undoubtably manage the company for short-term profits, sell off long-term assets, and discard the husk in a few short years. If Crown Z is successful in fending off the raid, it will be left weaker. High interest rates and the industry-wide timber depression has already cost 15,000 timber-based jobs in Washington state; we do not need to lose any more.

H.R. 1100 may not be the perfect piece of legislation, but it offers Congress a good start in dealing with the serious problem of corporate takeovers. These takeovers often leave a few individuals much richer, and entire communities far poorer. I am hopeful that the Committee and the Congress as a whole can craft a finely-balanced, tightly-drawn measure to help control this rising problem.

Thank you again for this opportunity to testify.

Chairman PICKLE. Now the Chair will ask Mr. Preston Martin to please come to the witness table.

Mr. Martin, do you have individuals with you?

Mr. Martin is the Vice Chairman of the Board of Governors of the Federal Reserve System; and if you have people with you you may identify them, Mr. Martin, either now or as you go along.

We are pleased to have you here, because we consider your testimony very much important to this overall hearing.

Would you proceed, Mr. Martin, with your statement.

STATEMENT OF PRESTON MARTIN, VICE CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. MARTIN. Thank you, Mr. Chairman.

I have with me staff members from the Board of Governors, Ms. Scanlon and Mr. Spillenkothen. I would ask the committee's indulgence to place my statement in the record in its entirety and, in an effort to save the committee's time——

Chairman PICKLE. It will be done, Mr. Martin. Thank you.

Mr. MARTIN. Thank you, Mr. Chairman.

Of course, I am pleased to appear before the committee to discuss the recent surge in merger and takeover activity and its potential effect on credit market conditions and its implication for monetary policy.

Prior testimony here underscores the importance of assessing the implications of this activity. The dollar size of recent transactions exceeds by a wide margin any past experience. Nonfinancial corporations as a whole retired an estimated $85 billion of equity last year through mergers, takeovers, and share repurchases. Included in this total is about $15 billion of equity retired through so-called leverage buyouts. That makes it important to review the growth in total equity of nonfinancial corporations; and that growth is very nearly constant. It is still positive, but not by a very large amount.

Aided by the 1981–82 depreciation rules, after tax earnings, corporations have rebounded strongly in the current expansion. With dividend growth remaining restrained, retained earnings have been a relatively substantial source of new corporate equity in recent quarters.

A less important source of equity is new stock issues. In 1983, we had a good growth in equity from that source; in 1984, much less so. And the wave of large financed mergers—LBO's—and stock repurchase programs retired $85 billion in equity just in 1984.

The mergers and buyouts have been more than offset by the strength in retained earnings, so that the net additions to equity

remain positive, but are very low by historical standards, especially for a business expansion. From another perspective, however, the data indicate that while nonfinancial firms as a whole are still making modest equity additions to their balance sheets, a few firms are retiring huge portions of their equity.

The tax laws are one component of a governmental structure which may have enabled merger acquisition and leverage buyout activity to accelerate. In my view, there is a legitimate place in our economy for mergers and takeovers, even unfriendly ones, and indeed it is very difficult to distinguish in the real world an unfriendly takeover from a friendly one. These acquisitions can be important mechanisms for redeploying assets to their most profitable and perhaps most socially desirable uses. Some have promoted economies of scale on the one side and on the other end of the spectrum some have resulted in substantial divestitures of operating units to their own managements. We must be careful about imposing the judgment of governmental authorities concerning which private transactions will be economically productive and which will not. Of course, the Federal Reserve's responsibility is to insure that individual risk-taking en masse does not jeopardize the stability of our financial system.

Let me turn, sir, if I may, to the implications for monetary policy. In the framing of that policy, the Federal Reserve monitors the growth in domestic nonfinancial debt, as the committee knows, so in part, our concerns have focused on the effect that mergers and takeover activity may have on aggregate credit flows. We also are concerned about the risk exposure of financial institutions and financial markets.

With respect to credit flows, our estimates indicate that growth in domestic nonfinancial debt, which we are monitoring, was boosted by between 1 and 1½ percentage points in 1984 as a result of merger-related borrowings. But mergers and buyouts appear likely to have had a much more limited impact on the three monetary aggregates—that is, the transactions balances and savings balances, for which we established target ranges under the Humphrey-Hawkins Act, and an especially limited impact on the narrow M-1 transactions money aggregate.

Moreover, the Board is made aware in our reviews and in the Federal Open Market Committee meetings of the merger and acquisition activity, and we take it into consideration when evaluating the behavior of the money aggregates and the debt aggregates.

Given our ability to monitor the size and timing of very large transactions, we can anticipate possible distortions in the aggregates over a particular period and thus avoid inadvertently reacting to these factors in our policy deliberations. So I do not believe that mergers, acquisitions, and takeover represent a real operational problem for us, one that would result in an appreciable unintended variation in market reserve pressures.

More fundamental determinants of credit demand, including the behavior of the household sector, capital expenditures of business, and, of course, the fiscal position of the Federal Government exert much more powerful and persistent pressures on credit markets than does takeover activity. Some members of the public and of Congress have expressed concerns that merger activities absorb

credit that could be used to support other perhaps more productive purposes, but this would be true only in unusual circumstances, and for very short periods.

Basically, merger and acquisition transactions involve transfers of ownership of existing assets and do not absorb net real savings in the economy. Proceeds from the transactions are either returned to bank accounts or reinvested in other financial instruments, thereby recycling the funds into the markets. That may take 6 months, 12 months, but at today's high interest rates, the money does not just lie there. A more pertinent consideration regarding merger financing from the Federal Reserve's position is the potential for greater risk exposure of the financial system. Because many mergers and leveraged buyouts have involved heavy reliance on debt and the retirement of existing equity, the companies are more vulnerable to downturns in earnings or sharp increases in interest rates.

When this occurs, it means the institution providing the credit may in turn be exposed to possible loss. That is our concern. Leveraged buyouts may be of particular note because they typically involve larger proportions of debt and smaller equity than mergers and other types of takeover transactions. The Federal Reserve has actively urged banks to apply prudent standards to their credit decisions; and our examiners have been instructed to review banks' involvement with leveraged buyout financing specifically. We have issued specific guidelines for the examiners to follow, and we treat this as though it were a concentration of lending in a particular industry, the concentration on mergers, acquisitions, LBO's and so forth.

A policy directive issued in 1984 to our examiners in each of the 12 District-Federal Reserve banks, which is followed up on from time to time, pointed out that the high volume of debt relative to equity characteristic of LBO's reduces the cushion available to the company to withstand unanticipated financial pressures or economic adversity. Moreover we have expressed our concerns with leaders of the banking community through public statements and through informal discussions with them. Members of the banking community have indicated that they are reviewing lending practices to assure that prudent standards are being applied; of course, that is only anecdotal evidence.

Reportedly, a number of attempted buyouts have been terminated as a result of difficulties encountered in obtaining needed financing, which would suggest some selectivity on the part of lenders. We expect and demand that prudent lending standards will be applied by commercial bank holding companies, including the administration of so-called junk bonds and portfolios with securities bonds that may have been taken back by the bank when there had been difficulties with the loans.

The large investors who have purchased most of these bonds are relatively sophisticiated and should be aware of what the risks involved are, and what the ratings are, but one cannot really say that one should be entirely comfortable about such assumptions, especially when the market has not been tested by some significant negative surprises, which inevitably will come.

The much higher rates of return paid on the low-rated and unrated bonds suggests that they are perceived by the market to involve greater risks. The question is whether the risk premiums will, in fact, prove to be adequate. Lending to finance mergers and acquisitions need not weaken the financial fabric, however. Although the companies that have been created in this recent surge of merger activity are still relatively untested, we at the Federal Reserve have not seen to date any significant problems for financial markets arising out of this activity. In part, this may reflect the favorable economic and financial environment of the current expansion.

While some individual firms have taken on greater leverage, other businesses have taken advantage of improved conditions to strengthen their balance sheets. And finally, to the extent that diversification is followed by a divestment, and this results in a smaller organization with a different motivation for the management of those organizations, it can be both profitable and efficient.

We do not believe that arbitrary controls or extensive Tax Code changes related to uses of credit are desirable. Some measures would likely reduce shareholder benefits. A given transaction may be desirable from a social and economic standpoint if it results in economies of scale, better management or other advantages.

Moreover, attempts to regulate the flows of credit for particular purposes run the risk of creating unintended distortions in these credit flows, and impeding the most efficient allocation of capital, because we know there is some status quo management out there, some big conglomerates which are not managed efficiently and their market prices reflect this. Not all bureaucracies are in government.

I do not wish to imply, however, that we should simply be complacent about mergers and acquisitions. The Federal Reserve will continue to monitor merger activity and its effect on financial markets. Our examination standards in this regard are undergoing further review; and we are involved in further training of our examiner staffs and their supervisors.

Congress and governmental agencies need to give close scrutiny to the numerous offensive and defensive practices that have arisen in association with mergers, leveraged buyouts and takeovers to insure that institutions and the stockholder population are provided adequate protection.

Mr. Chairman, I thank you for your courtesy in permitting me to make this statement.

[The prepared statement follows:]

STATEMENT OF PRESTON MARTIN, VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

I am pleased to appear before you to discuss the recent surge in merger and takeover activity and the potential effect of this activity on credit market conditions.

The magnitude of recent merger trends underscores the importance of assessing the implications of this activity, as you are reviewing in these hearings. The number of completed merger transactions in 1984 totaled more than 2,800; and it seems that almost every day we read in the press of a new combination of firms or a threatened takeover. These figures may not be unprecedented; in the late years of the 1960s, for example, more firms reportedly were involved in merger activity (attachment 1). But the dollar size of recent transactions exceeds by a wide margin any past experience. The largest acquisition in 1984 totaled $13.3 billion, nearly twice as

large as any single merger of previous years. Indeed, last year there were 14 merger transactions that exceeded $1 billion each (attachment 2). These 14 combinations alone accounted for more than $50 billion in activity.

Many more smaller transactions bolstered the total dollar volume of acquisition activity to record levels last year; during 1984, nonfinancial corporations retired an estimated $85 billion of equity through mergers, takeovers, and share repurchases. Included in this total is about $15 billion of equity retired through so-called leveraged buyouts, which rely heavily on debt financing. In a typical leveraged buyout, an individual or small group of investors and/or management purchases a company or subsidiary of a company with the proceeds of loans collateralized by the assets of the company, and then takes the company private.

In my view, there is a legitimate place in our economy for mergers and takeovers. They can be important mechanisms for redeploying corporate assets to their most profitable—and socially beneficial—uses, and for bringing about better management. We must be careful about attempting to impose the judgment of governmental authorities about which among thousands of private transactions will be economically productive and which will not; in most instances the parties whose fortunes are at stake are likely to be better judges. Governmental authorities are obliged to do what they can to ensure that individual risk-taking does not jeopardize the stability of our financial system. As I will discuss below, the Federal Reserve recognizes its responsibilities in this area.

Assessing the implications of merger activity is complex. From the perspective of the Federal Reserve, concerns have focused on the effect that this activity is likely to have on aggregate credit flows and on the risk exposure of financial institutions and markets. We all are aware that a large portion of these merger transactions has been financed, at least initially, with debt, including short-term bank credit. Leveraged buyouts typically entail as much as 80 to 90 percent debt financing; and among the largest mergers last year, credit sources initially financed about 75 to 80 percent of the equity purchases.

Estimates by Board staff indicate that growth in the domestic nonfinancial debt aggregate—which is one of the aggregates that the Federal Reserve monitors in the course of its monetary policy deliberations—was boosted by about 1 to 1½ percentage points in 1984 as a result of merger-related borrowings. Mergers and buyouts appear likely to have had a much more limited impact on the narrow money aggregate, M1. The checking accounts of merger participants may be increased temporarily as a result of the mergers, but proceeds from merger sales are generally reinvested in other assets, so that the effect on M1 tends to be insignificant over periods of time relevant for monetary policy deliberations. The broader aggregates, M2 and M3, may be boosted somewhat more than M1, as some proceeds from stock sales find their way into time deposits, money market mutual funds, or other assets that are included in these aggregates. But relative to the large size of M2 and M3 this effect also would be relatively minor.

The Board is aware of the influence of merger activity and takes it into consideration when evaluating the behavior of the money and debt aggregates. Given our ability to monitor the size and timing of very large transactions, we can anticipate possible distortions to the aggregates in a particular period and thus avoid inadvertly reacting to these factors in policy deliberations. Moreover, distortions in the credit aggregate, where the potential problems are largest, are less likely to mislead policy deliberations. In setting monitoring ranges for this aggregate, the FOMC recognizes that numerous factors, including merger activity, may alter the behavior of credit growth relative to GNP. Thus, I don't believe mergers present a real operational problem for us that would result in appreciable unintended variations in reserve market pressures. More fundamental determinants of credit demand, including the behavior of the household sector, capital expenditures of businesses, and, of course, the fiscal position of the federal government, exert much more powerful and persistent pressures on credit markets than does takeover activity.

Some members of the public and Congress have expressed concerns that merger activity absorbs credit that could be used to support other, perhaps more productive, purposes. But this would be true only in unusual circumstances and for temporary periods. Basically, merger and acquisition transactions involve transfers of ownership of existing assets and do not absorb net real savings in the economy. Proceeds from the transactions either are returned to bank accounts or reinvested in other financial instruments, thereby recycling the funds into the markets. Thus, these transactions should not generate significant lasting reductions in the amounts of financial resources available to other borrowers.

However, mergers may alter the cost or amount of credit available to some borrowers if banks that extend large amounts of takeover credit are subject to capital

or liquidity constraints and reduce their lending to other potential borrowers for a time. In this case, those borrowers with limited access to financial markets would be vulnerable to the potential effects of these transactions. However, in the case of many mergers, corporations have begun to repay loans, frequently within a month or so after the takeover, with funds raised through sales of assets or new equity, or by borrowing in the commercial paper or bond markets. More than two-thirds of the $32 billion of bank loans extended to finance the largest mergers last year has been repaid (attachment 3); the bulk of these repayments occurred within 6 months of the loan extensions. A number of foreign banks also have participated in the financing arrangements of many of the larger mergers, thus expanding the supply of funds in domestic markets. Among the largest transactions completed last year, approximately $7 billion, about one-fifth, of the intitial bank financing reportly came from foreign banks (attachment 3). Foreign banks have also purchased merger loans originally made at large U.S. banks, though we have no statistics on the total volume of this activity.

A more pertinent consideration regarding merger financing from the Federal Reserve's perspective is the potential for greater risk exposure of the financial system. The Board of Governors, as bank and bank holding company supervisor and lender of last resort, has responsibility along with the other regulatory agencies for maintaining the safety and soundness of financial institutions and markets. In this regard, we are especially concerned about potential financial risks involved with leveraging and with acquisition activity financed with large amounts of debt. Because many mergers and leveraged buyouts have involved heavy reliance on debt and retirement of existing equity, the surviving firms have had balance sheets that leave them more vulnerable to downturns in earnings or sharp increases in interest rates. When this occurs, it of course means that the institutions providing the credit may in turn be more exposed to possible loss.

Leveraged buyouts may be of particular concern because these purchases are typically executed using larger proportions of debt and smaller amounts of equity than mergers. In 1984, leveraged buyout deals involving U.S. companies are estimated to have amounted to over $15 billion, with buyers rarely putting up more than 10 percent of the purchase price. The ability of the firm to service this debt burden depends on the value of the assets and on the company's future earnings and cash flow prospects. These factors may be particularly difficult to evaluate for buyouts, if past operations are not expected to be a guide to future profitability—which is, after all, the economic rationale of many buyouts. Because buyout loans usually involve floating rate debt, the companies would be particularly vulnerable in the event that interest rates rise substantially and cash flows are not adequate to service heavy debt burdens. But prudent lending practices established by lenders take these possible outcomes into consideration, and thus help to insure that any failures associated with heavy leveraging would be only isolated events.

The Federal Reserve has actively urged banks to evaluate carefully loans used to finance buyouts and other types of takeover transactions and to apply prudent standards in their credit decisions. Bank examiners have been instructed to review banks' involvement with leveraged buyout financing, and we have issued specific guidelines for the examiners to follow in evaluating loans used for this purpose, and for assessing the total exposure of a bank to such lending. A policy directive issued in 1984 to examiners at each of the 12 District Federal Reserve Banks by the Director of the Board's Division of Banking Supervision and Regulation pointed out that the high volume of debt relative to equity that is characteristic of leveraged buyouts reduces the cushion available to the purchased company to withstand unanticipated financial pressures or economic adversity (attachment 4).

The Board policy directive noted the following two financial risks associated with leveraged buyout financing: (1) the possibility that interest rates may rise higher than anticipated and thereby significantly increase the purchased company's debt service burden; and (2) the possibility that the company's earnings and cash flow will decline or fail to meet projections, either because of a general economic recession or because of a downturn in a particular industry or sector of the economy.

The Board directive stated that, given the amount of debt involved in leveraged buyouts, the value of collateral should be emphasized in order to protect the creditworthiness of these loans. The quality of a purchased company's management is also important and represents another element in the bank's evaluation of leveraged buyouts. This is because management must oversee both the special financial risks associated with the leveraged buyout form of acquisition financing as well as the normal day-to-day affairs and operations of the purchased company's business.

The Board of Governors has expressed its concerns about the potential hazards of mergers and leveraged buyouts with leaders of the banking community through

public statements and informal discussions. Members of the banking community have indicated that they are reviewing lending practices to ensure that prudent standards are applied to potential credit extensions for takeovers. Reportedly a number of attempted buyouts have been terminated as a result of difficulties encountered in obtaining needed financing. At least $3 billion of proposed leveraged buyouts were abandoned last year because financing was not available, and we have read in the press recently of two or three sizable buyouts that were terminated for this reason. These reports suggest some selectivity on the part of lenders.

We hope that prudent lending standards will be applied by all lenders, including purchasers of so-called "junk bonds". Junk bonds are low-rated or unrated bond issues, which seem to have gained popularity as a tool for financing mergers and takeover attempts. The large investors who purchase most of these bonds are relatively sophisticated and should be aware of the risks involved. But it would be fair to say that one cannot really be entirely comfortable about such assumptions, especially when the market has not been tested by some significant negative surprises–which inevitably will come at some point. The higher rates paid on the junk bonds suggest that they are perceived by the market to involve greater risks; the question is whether the risk premiums will in fact prove to be adequate.

I should note that, while federally chartered depository institutions may make loans to low-rated borrowers, they are prohibited from acquiring junk bonds in their investment portfolios because they are not considered to be investment grade securities. But some state-chartered institutions may not be subject to such restrictions, and some state-chartered thrifts have purchased these securities. Given the evident sensitivity of financial markets to the fortunes of individual banks and thrift institutions, I think it is incumbent upon supervisors at both the federal and state levels to keep a close eye on developments in this area.

Lending on a prudent basis to finance mergers and acquisitions need not weaken the financial fabric. Although the companies that have been created out of this recent surge in merger activity are still relatively untested, we have not seen to date significant problems for financial markets arising out of this activity. In part, this may reflect the favorable economic and financial environment of the current expansion. Most sectors have experienced substantial increases in corporate profits and cash flows over the past year and interest rates are appreciably below the levels of the early 1980s. While some indvidual firms have taken on greater leverage, other businesses have taken advantage of improved conditions to strengthen their balance sheets. For the economy as a whole, retirements of equity through mergers and merger-related activity have been partially offset by improvements in the market values of assets and by boosts to equity from retained earnings growing out of the current expansion.

We do not believe that arbitrary controls of uses of credit can be effective or desirable. Nor can a government agency determine among thousands of mergers which are good and which are bad. A given transaction may be desirable from a social and economic standpoint if it results in economies of scale, better management or a more efficient allocation of resources. A blanket prohibition of all merger financing would be undesirable. Moreover, attempts to regulate flows of credit for particular purposes run the risk of creating unintended distortions in credit flows and impeding the efficient allocation of capital. When credit controls are in existence for any length of time, they become increasingly inequitable as borrowers and lenders seek to circumvent them. Credit controls are usually extremely difficult to enforce: since credit is fungible, most financing can be achieved through alternative channels, such as borrowing through nonregulated intermediaries, foreign lenders, or the like.

I do not wish to imply, however, that we should be complacent about the implications of lending for mergers and takeovers. The Federal Reserve will continue to monitor this activity and its effects on financial markets, and our examination standards in this regard are undergoing further review. And Congress and other governmental agencies need to give close scrutiny to the numerous offensive and defensive practices that have arisen in association with mergers, leveraged buyouts, and hostile takeovers to ensure that institutions and investors are provided adequate protection. Also, a careful review should be given to features of the tax system that appear to encourage merger activity, and in particular those features that favor the use of debt financing.

ATTACHMENT 1

MERGER AND ACQUISITIONS OF U.S. CORPORATIONS[1]

[Dollar amounts in billions]

	Completed transactions[2]		Announced transactions[3]	
	Number	Dollar volume	Number	Dollar volume
Year:				
1967	1,800	$15.0	2,975	NA
1968	2,440	28.0	4,462	$43.6
1969	3,012	NA	6,107	23.7
1970	1,318	NA	5,152	16.4
1971	1,269	NA	4,608	12.6
1972	1,263	NA	4,801	16.7
1973	1,064	NA	4,040	16.7
1974	1,088	NA	2,861	12.5
1975	859	NA	2,297	11.8
1976	1,058	NA	2,276	20.0
1977	1,139	NA	2,224	21.9
1978	1,364	NA	2,106	34.2
1979	1,420	NA	2,128	43.5
1980	1,470	34.7	1,889	44.3
1981	2,231	72.4	2,395	82.6
1982	2,182	65.1	2,346	53.8
1983	2,191	50.5	2,533	73.1
1984	2,807	122.0	2,543	122.2

NA—Not available.

[1] Purchases of U.S. corporations by other U.S. companies and by foreign companies. Divestitures or sales of subsidiaries, divisions, or product lines also are included.

[2] Data from Mergers and Acquisitions magazine. Includes transactions valued at $1 million or more in cash, market value of capital stock exchanged, or debt securities. Partial acquisitions of 5 percent or more of a company's capital stock are included if the size requirement is met. Data shown for the number of transactions completed in the years 1970-79 exclude divestitures and foreign acquisitions.

[3] Data published by W.T. Grimm. Data represent announcement of transactions, some of which were not actually completed. The series records announcements of any transfer of ownership of at least 10 percent of a company's assets or equity. Foreign acquisitions of U.S. companies also are included.

ATTACHMENT 2

LARGEST MERGER AND ACQUISITION TRANSACTIONS OF U.S. COMPANIES[1]

[In millions of dollars]

Acquiring company	Acquired company	Total price paid	Initial means of payment to selling stockholders			Subsequent public stock offerings
			Cash	Stock	Debt	
1984:						
Chevron	Gulf	13,300	13,300	--	--	--
Texaco	Getty Oil	10,120	10,120	--	--	113
Mobil	Superior Oil	5,700	3,800	--	1,900	--
Royal Dutch/Shell	Shell Oil	4,500	4,500	--	--	--
KMI Continental[2]	Continental Group	2,750	2,750	--	--	--
Beatrice	Esmark	2,725	2,725	--	--	--
General Motors	Electronic Data Sys	2,500	1,900	600	--	191
Champion Int'l	St. Regis	1,840	1,000	840	--	--
Dun & Bradstreet	A.C. Nielsen	1,300	--	1,300	--	--
IBM	Rolm	1,260	--	--	1,260	--
PACE Industries[2]	City Investing	1,250	1,250	--	--	--
American Stores	Jewel Cos	1,150	817	333	--	--
JWK Acquisition[2]	Metromedia	1,130	825	--	305	--
Texas Eastern	Petrolane	1,040	1,040	--	--	--
Total		50,565	44,027	3,073	3,465	304
1985:						
Nestle	Carnation	3,000	3,000	--	--	--

LARGEST MERGER AND ACQUISITION TRANSACTIONS OF U.S. COMPANIES[1]—Continued

[In millions of dollars]

Acquiring company	Acquired company	Total price paid	Initial means of payment to selling stockholders			Subsequent public stock offerings
			Cash	Stock	Debt	
Rockwell International	Allen Bradley	1,650	1,650	--	--	--
Textron	Avco	1,380	1,380	--	--	--
Pending:						
Coastal	Am. Nat. Resources	2,460	2,460	--	--	--
Chesebrough-Ponds	Stauffer Chem	1,250	1,250	--	--	--
Royal Dutch/Shell	Shell Oil[3]	1,170	1,170	--	--	--
Capital Cities Commu	ABC	3,500	3,400	100	--	--
Cooper Industries	MC-Graw Edison	1,400	1,400	--	--	--

[1] Acquisitions of $1 billion and over of shares in U.S. companies. Divestitures are excluded. Data are based on public information.
[2] Leveraged buyout.
[3] Final portion of Shell shares.

ATTACHMENT 3

LARGE MERGER-RELATED BANK CREDIT DEVELOPMENTS IN 1984

[In billions of dollars]

	Total (United States and foreign banks)	Estimated U.S. bank participation[1]
Estimated large credit lines arranged for potential acquisitions of U.S. nonfinancial firms in 1984[2]	57.9	35.5
Merger-related loans taken down[3]	31.9	24.9
Memorandum: Total loans outstanding at all banks, December 1984 (excluding interbank loans)	--	1,326.8

[1] Includes U.S.-chartered commercial banks, U.S. branches and agencies of foreign banks and foreign branches of U.S. banks where known.
[2] Includes credit lines of Texaco, Chevron, ARCO, Mobil, Teledyne, Limited/Carter Hawley Hale, Beatrice Foods, JWK (Metromedia), Champion, American Stores, Texas Eastern, Kiewit-Murdock, Nestle, Houston Natural Gas, Gulf and Western, Textron, Phillips Oil, PACE Industries.
[3] Amounts reflect estimated maximums taken down before repayments commenced. Substantial repayments (over two-thirds of the total) were made by borrowing companies using proceeds of borrowings in the commercial paper and bond markets as well as from sale of assets. Three of the credit lines arranged for merger financing were not taken down in 1984.

ATTACHMENT 4

GUIDELINES FOR EVALUATING LEVERAGED-BUYOUT LOANS

The Board directive to its bank examiners specified the following examination guidelines to supplement existing loan procedures:

1. In evaluating individual loans and credit files, particular attention should be addressed to i) the reasonableness of interest rate assumptions and earnings projections relied upon by the bank in extending the loan; ii) the trend of the borrowing company's and the industry's performance over time and the history and stability of the company's earnings and cash flow, particularly over the most recent business cycle; iii) the relationship between the company's cash flow and debt service requirements and the resulting margin of debt service coverage; and iv) the reliability and stability of collateral values and the adequacy of collateral coverage.

2. In reviewing the performance of individual credits, examiners should attempt to determine if debt service requirements are being covered by cash flow generated by the company's operations or whether the debt service requirements are being met out of the proceeds of additional or ancillary loans from the bank designed to cover interest changes.

3. Policies and procedures pertaining to leveraged buyout financing should be reviewed to ensure that they incorporate prudent and reasonable limits on the total *amount* and *type* (by industry) of exposure that the bank can assume through the financing arrangements.

4. The bank's pricing, credit policies and approval procedures should be reviewed to ensure i) that rates are reasonable in light of the risks involved and ii) that credit

standards are not compromised in order to increase market share. Credit standards and internal review and approval standards should reflect the degree of risk and leverage inherent in these transactions.

5. Total loans to finance leveraged buyouts should be treated as a potential concentration of credit, and if, in the aggregate, they are sufficiently large in relation to capital, the loans should be listed on the concentrations page in the examinations report.

6. Significant deficiencies or risks regarding a bank's leveraged buyout financing should be discussed on page 1 of the examination report and brought to the attention of the board of directors.

Chairman PICKLE. We thank you, Mr. Martin, and we appreciate your testimony. We will all be reading and studying your statement.

I was impressed with the fact that you observed at the very beginning that leveraged buyouts typically entail as much as 80 to 90 percent debt financing, and among the largest mergers last year, credit sources initially financed about 75 to 80 percent of the equity purchases.

Mr. MARTIN. Yes, sir.

Chairman PICKLE. That has to be a matter of considerable concern to the Federal Reserve.

Mr. MARTIN. Yes, sir; it is, indeed.

Chairman PICKLE. Now, you said you have a directive out. You said that you are cautioning people to be careful and while it is not an overall problem in the aggregate credit flow; heavy reliance on debt is something that could have a direct effect on the investors, the individual who might be involved in their purchases.

Now, Mr. Martin, I am trying to find something that we can do—it is not an easy matter, and we have got to be careful—with respect to some of the junk bonds that you make reference to that you said could be risk factors if there was a negative impact on our market. Can you tell me in what amounts are federally insured financial institutions investing in junk bonds?

Mr. MARTIN. No, sir; I do not have that information. We will make every effort to get it for you.

Chariman PICKLE. We think that is important to know to what extent these federally insured institutions are investing in these bonds.

Mr. MARTIN. We will contact the Comptroller of the Currency to obtain——

Chairman PICKLE. It could be a sizable sum, but you do not know what the amount is?

Mr. MARTIN. The last number I saw indicated that the aggregate growth in big merger related loans represented something like 1 to 1½ percent of the growth in total bank credit outstanding last year, but that is an extremely preliminary figure.

Chairman PICKLE. I understand that, but it is also a conclusion one could draw to say that most of these mergers, the big mergers, would not have come about if they did not have the use of the junk bonds; and while they may or may not be risky, the fact of the matter is, you would not have put the package together if you would not have had this kind of bonds, so that has to be a conclusion in general, does it not?

Mr. MARTIN. In the vast majority of cases, that is true. We have had enough European and Japanese foreign bank credit flowing

into our country involved in these that some of it could be financed, you know, without junk bonds.

Chairman PICKLE. On page 8 you said federally chartered depository institutions may make loans to low-rated borrowers, but they are prohibited from acquiring junk bonds in their investment portfolios because they are risky.

Now, what if we were to extend the prohibition to acquiring junk bonds to all federally insured financial institutions? What would be the effect?

Mr. MARTIN. The effect would be to stop both the direct purchase by, let's say, a savings and loan association or a State-chartered, nonmember commercial bank of securities that are rated below investment grade. Estimates of the volume of low-rated securities outstanding range as high as $100 billion. But, these figures are not based on hard data. In any case many of those securities have nothing to do with takeovers and mergers, leverage buyouts, et cetera.

Chairman PICKLE. I understand that, but you prohibit federally chartered institutions from acquiring junk bonds in their investment portfolio.

Mr. MARTIN. Yes, sir.

Chairman PICKLE. That is a good precautionary principle, and I am sure all the committee would agree to that.

Mr. MARTIN. Yes, it is, sir.

Chairman PICKLE. Now, suppose we extend that provision to federally insured financial institutions. Why do we let the investors, S&L's, State-chartered institutions, and pension funds, invest their funds; where they might get a little return now, but where they could also lose more? I am saying to you we should give some consideration to that approach, and I would like to have your considerations on that now or at some other point. It is an approach that we can take.

Mr. MARTIN. And I can support that, Mr. Chairman.

Chairman PICKLE. Thank you. I will stop there. I am glad to hear that.

Mr. Rangel.

Chairman RANGEL. I have no questions.

Chairman PICKLE. Mr. Schulze.

Mr. SCHULZE. I have no questions.

Chairman PICKLE. Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

I noted that your closing statement suggests a careful review should be given to features of the tax system that encourages merger activity, and in particular that favor debt financing. I assume you are referring exclusively to the deductibility of interest.

Mr. MARTIN. Yes; that certainly is one consideration.

Mr. FLIPPO. And the only area that you mentioned was junk bonds.

Mr. MARTIN. I would respectfully also suggest that in your review you will, of course, come across the whole process of writing up assets, which occurs in some acquisitions, redepreciation, redepletion, if you will. I am not against that, but it certainly warrants review.

Mr. FLIPPO. A new basis in that area.

Mr. MARTIN. Yes, sir.

Mr. FLIPPO. Junk bonds are not just used in corporate mergers and acquisitions. They are used in other instances in probably larger proportions than they are in mergers and acquisitions.

Should we deny the deductibility of interest?

Mr. MARTIN. That was my concern in the chairman's question, that not all so-called low-rated or unrated bonds are not the result of leveraged buyouts, and so forth. A company may have its rating decrease because it has fallen upon difficult years, and that is the reason for my hesitation on that subject.

Mr. FLIPPO. What makes junk bonds junk bonds?

Mr. MARTIN. The determination by one or more of the rating services, of Moody's, Standard & Poor's, or the smaller agencies, that following their analyses of the prospects of the company, of the debt-service coverage out of income and out of future income, and other debt protection parameters, that there is an element of speculative risk in the security where the future payment cannot be considered as well assured in adverse conditions. Some times it may be a brandnew company that does not have an earnings record. When I started a corporation some years ago, I went to Moody's to obtain a rating after I had been operating about three years, so they could see what my operating status was. Only then did I obtain a rating. Had I sold debt prior to that time as a new, growing company, I would have not had a rating on it. It would have been a junk bond.

Mr. FLIPPO. Is there any doubt that companies are using debt to finance these mergers, rather than equity because of deductibility of interest?

Mr. MARTIN. It certainly is a factor, the deductibility of the interest. But as a former corporate executive, I can say to you that there are other considerations that you undergo first, the risk of the company; how sure are we of getting the income in the future and how sure are we of paying the interest and the principal? If I am quite secure as to the return on my investment of expanding in different parts of the country, I will think of that first; and second, I am going to think of the tax consideration.

Mr. FLIPPO. I think my impression that the administration's testimony here is that we really do not need to be all that concerned about this merger situation; and how should I interpret your testimony that you are concerned about it; that you think that we should review those areas you are concerned about the increased debt levels associated——

Mr. MARTIN. I think the size of the flow of debt, particularly that component of it which replaces equity, is huge enough that it prompts a review, as this committee is rightly doing.

I do not come out of that by saying we ought to prohibit all these things and restructure all these things, but it certainly deserves a look.

Mr. FLIPPO. And you think the most fruitful area of our investigation, then, is in the area of junk bonds and on a stepped-up basis?

Mr. MARTIN. I think in terms of the committee's purview, yes. In what the Federal Reserve does we must continue to examine the

quality of the assets of the commercial banks that we examine and of the commercial bank holding companies.

Chairman PICKLE. Mr. McGrath?

Mr. MCGRATH. Thank you, Mr. Chairman. I am getting a little confused on the use and the viability of these junk bonds.

We had a witness last week from, I believe, Drexel Burnham, who told our subcommittee that the payout rates on junk bonds are better than those for investment grade bonds, and the default rates on junk bonds are less than the investment grade bonds.

What are the facts as you know them?

Mr. MARTIN. Well, sir, I think that is because we are at a certain point in time. If you go back to the default rates of recent years, it is quite true that they are quite low. Because of changes in our economy there have been downgradings and difficulties in companies that formerly had an AA rating or other investment grade A rating by Moody's, as they have fallen on difficult times, particularly in the heavy industry in this country which has been so impacted by foreign competition.

Now, the low-rated and unrated bonds have a very good realized rate of return, more than the investment grade bonds, but that is over a significant period of time. That is, the risk premium has more than compensated for the losses due to default.

I caution the gentleman that there is now such a volume of issuance of low-rated and unrated bonds that we cannot simply extrapolate the last few years favorable look on the junk bonds and say, well, that probably is what is going to happen in the future. That probably is not going to work that way.

Mr. MCGRATH. And you keep monitoring this phenomenon as it progresses?

Mr. MARTIN. Yes, sir.

Mr. MCGRATH. Thank you, sir.

Chairman PICKLE. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman

Mr. Martin, I know you are concerned about the health of the entire banking system. I must tell you, so am I. The State of Arkansas has just had some headlines over the past few days about one of our banks. They were forced to put up $32 million in extra capital over the weekend to make sure that the bank was solid and met the reserve requirements. But the reserve requirements are still only about 5½ percent.

It seems to me that the banks are terribly leveraged across this country.

Does that not give you some concern over and above the problem that we are having with mergers and the increasing debt that is floating around the countryside?

Mr. MARTIN. Congressman Anthony, we are continuing to ask the banking industry to increase the capital ratio to which the gentleman alluded. We are pushing the commercial banks of the country to increase both their primary capital and their secondary capital, to issue equity securities, to issue convertible securities, so they get their net worth up, and I am pleased to report to you that 1984 was a year in which such issues and such increases in the net worth position of the commercial banking system of the country, increased very substantially.

Mr. ANTHONY. When you say "increased substantially," from what percent to what percent?

Mr. MARTIN. Let me see if I can give you an exact figure. We will get that information for the gentleman. We do observe that in case after case, in large banks, money center banks have increased their net worth by the issuance of various kinds of securities and by retained earnings, so that almost without exception they now have over 6 percent primary capital ratio, and if you add in certain other kinds of reserves, and so forth, there are capital reserves above that, so it is improved from the fives of just a couple of years ago to the sixes of today, and that, we find, is very much in the public interest.

Mr. ANTHONY. Well, the public interest would dictate it be up 9 or 10, or even more than that if we really wanted to have the financial institutions on solid ground.

The reason I ask the question is that it seems to me that it is terribly interrelated with mergers. Your testimony and the other testimony in fact, reveals that the large chunk of the mergers are being financed by total debt. Even in your own testimony you talk about these raiders coming in and only putting up 10 or 15 percent.

I walk the streets of my hometown. They go see their friendly bank and they want to buy a new car, because their old car is worn out. Well, they will make them put up 25 percent just to buy an old car, and they know where they live, they knew where the car is, and they know what the value of it will be afterward; and we talk about billions of dollars and they say put up 10 percent and go out and finance 90 percent of it. It appears that the whole system is topsy-turvy.

What this tells me is that banks ought to get as big as they can get, and act as sloppy as they want to because nobody is going to let them fail. However, small banks have to act responsibly because no one will try to save them. I am personally interested in the impact on the entire financial system that these mergers and acquisitions have.

Boone Pickens, who testified last week, told us in response to a question that he was financing his debt off the reserves of Mesa. Well, it appears that he has changed that view since he came in and testified because he is now leveraging out the stock that he bought by forming a new company, borrowing on the margin. Now, through another mechanism, he is actually borrowing on the assets of that new company. This tells me there is a lot of pressure on debt out there and there is a pressure on the little guy. If we do not do something about this, it is even going to get worse, and it is going to be the little guy who is going to continue to pay for it.

Now, that was more in the form of a statement than a question. Since my time is out, if you would like to respond to it, I am sure the chairman would give you an opportunity to do so.

Chairman PICKLE. Would you care to respond to it, Mr. Martin, at this point?

Mr. MARTIN. Well, certainly, Mr. Chairman, there are elements in the statement that I would certainly like to subscribe to. We are all aware that the growth and employment in this country has been unparalleled around the globe; that is, 7 to 8 million addition-

al new jobs, people newly employed, have occurred in this expansion. That is not true of any other section of the globe.

We are also aware that the overwhelming majority of that 8 million have been in smaller business enterprises, so certainly the "allocation"—that is the wrong word—the availability of credit to the small employer, so that he or she can add to that work force is a very, very important factor in our whole Nation; and I would certainly echo that fact.

Chairman PICKLE. Mr. Frenzel.

Mr. FRENZEL. Thank you very much for your testimony.

This morning, in the local newspaper, Joe Kraft writes that perhaps these bonds give a shakiness to our financial system. I infer—maybe he does not imply—that the taxpayers are ultimately going to pick up some of the cost of this kind of a speculative issue.

Can you set our minds at rest over that question?

Mr. MARTIN. Well, sir, as I remember Mr. Kraft's column, he stressed the issuance of junk bonds rather than direct bank credit. The junk bonds carry a much higher risk; they carry a much higher rate of return, and I believe that not even the Congress of the United States has ever repealed the economic law which relates risk and reward.

If you are going to get 16 percent on that security, there is a reason there is a risk. So sometime when we, God forbid, come into a recessionary period, and sometime in which particular industries which have a heavy volume of unrated, or low-rated securities outstanding, there are going to be some defaults and the holders of some securities are going to lose. But I submit to you they have been getting a pretty good return.

In some cases they have gotten capital gains, as well as high returns, and their rewards are going to be matched by those losses, those risks out in the future.

Mr. FRENZEL. Your testimony indicates that the banks have restrictions about buying this kind of security.

Mr. MARTIN. Yes, sir; member banks and national banks cannot buy those securities.

Mr. FRENZEL. What is the prohibition? Is it a regulation of yours, or the Comptroller's, or whose?

Mr. MARTIN. It is both. For the Comptroller of the Currency–there is statutory language directing the Comptroller, and it is in our regulations.

Mr. FRENZEL. It has to do with the investment grade of the instrument.

Mr. MARTIN. Yes, sir.

Mr. FRENZEL. How about the other situation where, as I understand in the case of the current oil company, the Mesa Group, in addition to junk bonds, has used the margin borrowings and a billion-dollar line of credit with some of the major banks. Are your banks involved in that line of credit?

Mr. MARTIN. If they are State-member banks, they might be, Mr. Frenzel. I do not know from my own knowledge which banks are involved.

Mr. FRENZEL. I do not either, but I assume there is some risk, because a number of these things do use bank lines of credit, at least for partial financing of the takeover attempts.

Mr. MARTIN. Yes; typically, there is some bank credit involved in them.

Mr. FRENZEL. And you have no regulations forbidding banks from making loans for these purposes?

Mr. MARTIN. No; because the financing of mergers and acquisitions, most mergers and acquisitions are on a so-called friendly basis, and they have benign economic consequences in many cases. We do not stop the financing of mergers and acquisitions.

Mr. FRENZEL. Thank you very much.

Chairman PICKLE. Mr. Martin, I thank you for testifying. Before you leave, at the conclusion of your testimony you said that a careful review should be given to the feature of the tax system that appears to encourage merger activity, and particularly those features that favored debt financing. Just what did you mean by that when you said we ought to give a careful review to the future of the tax system that encourage merger? What do you mean by that?

Mr. MARTIN. I think, Mr. Chairman, that the whole question of the changing of the basis, changing of assets after an acquisition is one factor that may warrant review.

I think the deductibility of interest in the cases of credit extended and involved in mergers and takeovers is one area. I think that there are other tax considerations in the so-called tax-free reorganization that at least warrant a look.

Chairman PICKLE. Do you think we might give serious consideration to prohibiting, or eliminating, or controlling the deductibility of debt financing?

Mr. MARTIN. We do not have a position on that. We are not convinced that the Fed's role ought to be to set ourselves up as authorities on the tax system.

Chairman PICKLE. Do you mean by that that you would allow the deductibility of dividends?

Mr. MARTIN. No, sir; we are not taking a position on any of those specifics in the Treasury proposals or in Congessman Jones' bill.

Chairman PICKLE. A moment ago you said, and I assume you are talking about the Reserve Board, as far as you can speak as an individual, would support the——

Mr. MARTIN. The Board.

Chairman PICKLE [continuing]. Prohibition of acquiring junk bonds by federally insured institutions, and I am glad to hear that, because I think if you have a prohibition on the federally chartered, you ought to have it for the federally insured, too. I wonder why the Federal Reserve has not done that already.

Mr. MARTIN. Well, the action would have to be by other agencies other than ourselves. We and the Comptroller of the Currency are already there. It is the other two agencies and the State governments, you know, the State banking superintendents and so forth.

Chairman PICKLE. But you would support that approach, then?

Mr. MARTIN. Yes, sir. With reservations.

Chairman PICKLE. If you were to limit the purchase of junk bonds; that is, the low-rated bonds by all banks, who would be left to purchase bonds?

Mr. MARTIN. Well, most of the bonds are not purchased by commercial banks or thrift institutions. Most of the time they are purchased by money managers, pension funds, institutional holders of

various kinds, and the so-called Wolfpack, the individuals who have made themselves very wealthy in trading in junk bonds.

Chairman PICKLE. Are you saying now that most of the money comes from private investors or pension funds?

Mr. MARTIN. Mutual funds, institutional investors.

Mr. PICKLE. And not S&L's or federally insured institutions?

Mr. FLIPPO. Would the Chair yield?

Chairman PICKLE. Yes.

Mr. FLIPPO. If the committee and the Congress did eliminate the deduction of interest on junk bonds, would that have a negative impact on startup firms? Would that increase their cost of capital or the availability of their funds?

Mr. MARTIN. Yes, sir; I think that is important for a startup firm.

Mr. FLIPPO. So we should be careful about that approach.

Mr. MARTIN. Yes, sir.

Mr. FLIPPO. Is it fair to say that our current Tax Code is a major factor in encouraging corporate America to become highly leveraged and thereby increasing the risk in a business downturn in which many people would, if we did have a business downturn, and the risk that more firms would be more susceptible to going under and people would certainly be hurt by such a course of action?

Mr. MARTIN. I think it is fair to say that the impact of the Tax Code, the Federal Tax Code, upon corporate decisions, including those decisions as to degree of leverage and the degree of risk-taking, is a very mixed one. The ACRS and the investment tax credit favor the accumulation of equity, because the earnings are retained in the net worth on the balance sheet. The deductibility of interest and the ability to write up assets in an acquisition tend to push toward leverage. It is such a complicated code that has a number of impacts on corporate decisions.

I would say the well managed corporation does not primarily take action because of tax consequences, but does not take action in the ignorance of tax consequences.

Mr. FLIPPO. But if we treated equity and debt the same for tax purposes, then that motivation would not be there for increased leverage?

Mr. MARTIN. Yes, sir.

Mr. FLIPPO. Different in the way we tax benefits?

Mr. MARTIN. Yes, sir; my only response is that there are some instances in which the selling of debt instruments is a very proper and socially desirable activity.

Mr. FLIPPO. Thank you very much.

Chairman PICKLE. Mr. Martin, will you submit to this committee the percentage of investment in junk bonds by federally insured institutions, and if you have the information, the percentage of investment by pension funds, private investors or foreign banks? Can you give us that information?

Mr. MARTIN. Yes, sir; we will report that.

Chairman PICKLE. We might make one small step or one giant step, if we extend the current prohibition to federally insured institutions. We might have some way, then, to leverage the pension funds and maybe, too, the insurance companies, all of which have some involvement in this. At this point it looks like corporate

America is being leveraged, and we are trying to find some kind of solution, so we would appreciate any suggestions you would have for us, and we thank you for your testimony.

[The following was subsequently received:]

FEDERAL RESERVE SYSTEM,
BOARD OF GOVERNORS,
Washington, May 16, 1985.

Hon. J.J. PICKLE,
Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR CHAIRMAN PICKLE: During the hearing held on April 16 on corporate mergers and takeovers, I was asked to supply the Subcommittee with the following information:

1. The increase in the ratios of capital to assets for the banking system from 1983 to 1984.

2. The amount of "junk bonds" held by federally insured and other financial institutions.

Regarding the first item, I have enclosed a table showing primary capital ratios for banks classified by size, and a table showing ratios for selected bank holding companies. The data indicate that capital ratios have moved up fairly steadily in recent years; on average for all insured commercial banks, the capital ratio was just under 7 percent in September 1984. For large bank holding companies, the average ratio was 6.38 at year-end 1984.

The information on holdings of junk bonds by different types of institutions is less easily obtained. With regard to banks, I noted in my testimony that member banks would be precluded from investing in junk bonds. In particular, member banks are limited to investing in securities that are "investment securities" as defined in the Office of the Comptroller of the Currency's regulations (12 CFR 1.3b) (made applicable to state members by paragraph 20 of Section 9 of the Federal Reserve Act) which indicate that they not be speculative and they must be readily marketable. Junk bonds are considered speculative by most rating agencies and do not have a ready market. Our staff has contacted the Comptroller of the Currency to determine if they could provide any information with regard to national banks. They confirmed that national banks could not hold junk bonds as investments either directly or in their trust departments since they were speculative, had no ready market, and were not "prudent" investments for a fiduciary. They indicated further that their examiners had not yet encountered any situations of national banks investing in junk bonds and felt that it was not presently a supervisory problem. It seems, therefore, that the total held by banks would be limited to those held by state nonmember banks. Although the total held by state nonmember banks is unknown, it likely is small.

With regard to federally insured thrift institutions, the Federal Home Loan Bank Board (FHLBB) has, in press reports, estimated that the thrifts they supervise currently hold between $3 and $5 billion of low or unrated, high-yield securities. However, the FHLBB is in the process of surveying its institutions and should be able to provide more precise estimates and additional information on junk bond investments at thrifts soon. You may wish to contact the FHLBB directly for this information.

Federally chartered credit union investments in securities are limited to federally insured financial institutions or federally guaranteed federal agency securities or obligations. Therefore, they are precluded from investing in junk bonds. State-chartered credit unions are subject to state laws.

Available survey statistics on bond funds, including those that invest primarily in high-yield securities, indicate that these groups hold about $5.5 billion of such securities. Unfortunately, we have little information on the rating of bonds held by financial institutions other than the depository institutions.

I hope this information will be useful to your Subcommittee. Please let me know if I can be of further assistance.

Sincerely,

PRESTON MARTIN,
Vice Chairman.

Enclosures.

PRIMARY CAPITAL RATIOS[1] FOR ALL INSURED COMMERCIAL BANKS

[In percent]

	Asset size class					
	Under 100–million	100–300 million	300 million–1 billion	1 billion–5 billion	Over 5 billion	All banks
Year-end:						
1969	8.59	8.35	8.28	7.72	6.81	7.88
1970	8.51	8.31	8.15	7.27	6.41	7.59
1971	8.28	7.84	7.82	6.83	6.08	7.25
1972	7.98	7.53	7.28	6.32	5.56	6.81
1973	8.10	7.61	7.15	6.13	4.93	6.50
1974	8.42	7.81	7.34	6.42	4.65	6.49
1975	8.41	7.81	7.47	6.66	4.96	6.71
1976	8.47	7.71	7.40	6.57	5.02	6.66
1977	8.34	7.51	7.18	6.45	4.81	6.44
1978	8.50	7.66	7.09	6.36	4.63	6.33
1979	8.75	7.83	7.14	6.46	4.54	6.29
1980	8.96	7.86	7.36	6.27	4.63	6.34
1981	9.02	7.92	7.39	6.32	4.76	6.39
1982	9.13	7.95	7.37	6.37	4.94	6.48
1983	9.09	7.92	7.36	6.46	5.36	6.66
1984 (9 mo)	9.43	8.17	7.69	6.83	5.70	6.98

[1] Primary capital divided by total assets.

PRIMARY CAPITAL RATIOS

[In percent]

Name of bank holding company	Dec. 31, 1980	Dec. 31, 1981	Dec. 31, 1982	Dec. 31, 1983	Dec. 31, 1984
Bank of Boston Corp	5.22	5.58	5.52	5.85	6.92
BankAmerica Corp	3.99	3.89	4.29	5.10	5.89
Bankers Trust Corp	3.51	4.07	4.55	5.64	6.34
Chase Manhattan Corp	3.75	4.20	4.76	5.49	6.46
Chemical New York Corp	3.65	3.94	5.00	5.52	6.32
Citicorp	3.87	4.11	4.26	4.89	5.89
Crocker National Corp	4.47	5.23	5.34	6.28	6.42
First Chicago Corp	4.72	4.34	5.00	5.67	6.13
First Interstate Bancorp	5.11	5.03	5.07	5.84	6.18
Irving Bank Corp	3.86	4.32	4.73	5.25	5.93
Manufacturers Hanover Corp	3.56	3.79	4.63	5.00	5.77
Marine Midland Banks	4.36	5.04	5.65	5.79	7.08
Mellon National Corp	6.21	6.02	6.10	6.15	6.71
Morgan (J.P.) & Co	4.65	5.08	5.64	6.97	7.12
Security Pacific Corp	4.84	4.73	4.93	5.34	5.99
Wells Fargo & Co	4.59	5.03	5.20	5.72	6.74
Multinational average	4.40	4.65	5.04	5.66	6.37
First Bank System	6.39	6.24	6.02	5.90	5.75
First City Bancorporation	5.59	5.57	6.04	6.35	7.49
InterFirst	5.83	5.51	6.02	6.58	6.47
MCorp	6.87	6.39	6.19	6.38	6.07
NBD Bancorp, Inc	6.65	6.28	6.59	6.57	6.67
NCNB Corp	5.49	6.15	5.16	5.35	6.16
Norwest Corp	6.17	6.41	6.69	6.61	6.52
RepublicBank Corp	5.37	5.56	5.85	5.85	6.14
Texas Commerce Bancshares	6.13	5.53	5.42	5.89	6.40
Regional average	6.06	5.96	6.00	6.16	6.41
Overall average	5.00	5.12	5.39	5.84	6.38

FEDERAL RESERVE SYSTEM,
BOARD OF GOVERNORS,
Washington, June 3, 1985.

Hon. J.J. PICKLE,
Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR CHAIRMAN PICKLE: Thank you for your recent letter containing follow-up questions to my April 16 testimony on mergers and acquisitions before the Subcommittees on Oversight and Select Revenue Measures. I am pleased to enclose responses to your questions.

I hope these responses will be of use to the Subcommittee. Please let me know if I can be of further assistance.

Sincerely,

PRESTON MARTIN,
Vice Chairman.

Enclosures.

RESPONSES TO ADDITIONAL QUESTIONS ON MERGERS AND ACQUISITIONS

LEVERAGED BUYOUTS

According to your testimony, nonfinancial corporations retired approximately $85 billion of equity through mergers, takeovers, and share repurchases. Included in this total is about $15 billion of equity retired through leveraged buyouts (i.e., purchase of a company with proceeds of loans collateralized by the assets of the company, and then taking the company private).

a. What is the Federal Reserve Board's specific concern about this kind of activity?

Response:

The Federal Reserve, as a supervisor of member banks and bank holding companies and as a lender of last resort, has responsibility along with other regulatory agencies for the safety and soundness of financial institutions and markets. In this regard, we are concerned about risks to the financial system that may result from acquisition activity financed with large amounts of debt. Because leveraged buyouts involve heavy reliance on debt and retirement of existing equity, they reduce the cushion available to firms to withstand unanticipated financial pressures or economic adversity. The ability of the firm to service a heavy debt burden depends on the value of the firm's assets and on the company's future cash flow prospects. Cash flow prospects are often difficult to assess and past experience can be viewed as only a limited guide. Moreover, because leveraged buyouts usually involve floating-rate debt, the companies would be particularly vulnerable in the event that interest rates rise substantially and cash flows are not adequate to service these heavy debt burdens. Should this occur, the institutions providing the credit would be exposed to loss. Our concern is to ensure that lenders take into account these considerations and apply prudent credit standards in evaluating loans for leveraged buyouts.

b. Should there be restrictions on leveraged buyouts or on only large leveraged buyouts involving large companies?

Response:

The Federal Reserve Board does not support selective restrictions on particular types of transactions. A leveraged buyout may result in positive economic gains through better management or better use of resources; arbitrary restrictions on such activities run the risk of impeding the efficient allocation of capital. Rather, we believe that prudent lending practices followed by lenders will reduce the scope for adverse outcomes arising from such lending while enabling credit to be advanced for these transactions that enhance efficiency.

c. If the Federal Reserve Board's chief concern is the amount of debt on these mergers, is there a "rule-of-thumb" debt/equity ratio which is considered safe or considered generally acceptable?

Response:

There is no "rule-of-thumb" that can be effectively used to determine whether a particular firm's debt-to-equity ratio should be considered "safe" or "generally acceptable," and surely no single ratio can be applied across all firms and industries. Each loan must be evaluated on an individual basis taking into account all of the

relevant information on the companies involved, including the value of the collateral, the quality of the purchased company's management, and a host of other factors.

2. ECONOMIC IMPACT OF LARGE MERGERS

a. According to your testimony, the Federal Bank Examiners will be looking at banks' involvement in merger activity, specifically leveraged buyout financing. Could you give us some general idea of the rules that they will be applying and the type of evaluation they will be conducting?

Response:

The attached instructions to examiners describe the type of evaluations that are being employed with regard to lending to finance leveraged buyouts. The directive provides guidelines to supplement existing examination procedures, including, among others, instructions to emphasize the value of the collateral in an effort to protect the creditworthiness of the loans and to consider carefully the quality of management of the purchased company when making leveraged buyout loans. Of course, the Board continuously reviews our examination standards with respect to this activity.

b. For purposes of the Federal Reserve Board, does it make any difference whether the merger is "hostile" or "friendly"?

Response:

The Federal Reserve Board does not believe that distinctions between "hostile" and "friendly" takeovers can be defined adequately or that they are meaningful or useful for purposes of evaluating lending activity involved in financing these transactions. Governmental authorities must be careful about attempting to impose their judgments about which private transactions will be economically productive and which will not because such judgments run the risk of creating unintended distortions in credit flows and impeding important market functions.

3. JUNK BONDS (DEFINED AS LOW-RATED OR HIGH-YIELD BOND ISSUES)

a. In your testimony, you specifically stated that federally chartered banks may make loans to low-rated borrowers, but they are prohibited from holding the so-called junk bonds. What are the rules? Why is this the case?

Response:

Federal law provides that national banks may purchase investment securities for their investment portfolios and gives the Comptroller of the Currency the authority to define investment securities. The definition includes marketable securities that are not predominantly speculative (that is, those with quality equivalent to securities in the top four ratings). Federal law also provides that state member banks are subject to the same limitations on investment securities as national banks. State nonmember banks are principally subject to supervision and regulation by state authorities and may not be subject to equivalent restrictions under state banking law.

A bank's investment portfolio should be viewed primarily as a secondary reserve for liquidity so that the bank can use it as a source of funds when funds are needed. For this reason, the securities in the portfolio must be marketable and of high quality. Banks are able to make loans to low-rated borrowers because loans are subject to other restrictions, and, of course, the primary business of banks is to make loans, subject to prudent lending practices.

b. In your testimony, you indicated that you would support limitations on junk bond purchases by FSLIC- and FDIC-insured financial institutions. Please discuss further.

Response:

It is my personal view—though I cannot speak for all of the Board—that federally insured financial institutions should all be subject to the same restrictions that now apply to national banks and state member banks. Ensuring that the investment portfolios of these institutions contain marketable securities of sufficiently high quality that they can be used when needed should bolster the safety and soundness of these institutions. Thus, I believe that such restrictions would work to reduce potential pressures on the federal insurance programs administered by the FDIC and FSLIC.

c. A witness before our Subcommittee said that the payout rate on junk bonds is better than investor grade bonds.

1. Do you agree?

2. Are the default rates on junk bonds greater or less than investor grade bonds?
3. What other considerations are relevant?

Response:

The yields on junk bonds appear to be higher than those available on investment grade securities, as would be expected. The question of concern is whether these yields are adequate to compensate investors for the higher levels of risk they bear when holding these securities. Many of the companies involved in the recent surge in low-rated bond offerings have not yet had to withstand significant adverse events, such as a cyclical downturn in cash flow or sharply higher interest rates. Thus, we do not know whether realized rates of return will be adequate to compensate investors for the risk they have undertaken in purchasing these securities.

Statistical studies based on historical data indicate that prices of low-rated securities were more volatile and default rates were higher than for investment-grade securities. These same studies show that, even though low-rated bonds had higher realized rates of return on average over most long periods of time, during periods of severe economic contraction their realized returns were substantially lower. That is, higher yields offered on low grade securities did not always fully compensate investors for the higher default rates that occurred during recessions or periods of sharply rising interest rates.

4. INTERNAL REVENUE CODE AND MERGERS

In testimony before our Subcommittee you indicated that a careful review should be given to the features of the tax system that appear to encourage merger activity and, in particular, those features that favor the use of debt.

a. What specific measures do you endorse?

b. Would you support a reduction or elimination of the deduction for interest on debt in merger activity? In what circumstances?

c. Do the tax provisions that allow for a step-up in asset basis in certain mergers represent a problem that concerns the Federal Reserve Board?

Response:

As a general matter, the Federal Reserve Board does not endorse specific features or proposed changes to the tax system, but believes that the appropriate level and disposition of taxes are matters best left to the decisionmakers in the Congress and other governmental agencies. We do encourage you, in making these decisions, to recognize the impacts that the tax code can have on the behavior of businesses and individuals in an effort to avoid unintended adverse effects on the financial system.

ATTACHMENT

GUIDELINES FOR EVALUATING LEVERAGED BUYOUT LOANS

FEDERAL RESERVE SYSTEM,
BOARD OF GOVERNORS,
Washington, DC, June 7, 1984.

To the officer in charge of examinations at each Federal Reserve Bank.
Subject: Leveraged buyouts.

Leveraged buyouts have become an increasingly important and prevalent acquisition financing technique which, by definition, entail high levels of debt. Bank involvement in leveraged buyouts and the manner in which some leveraged buyouts have been structured have potential implications for the quality of bank loan portfolios. Examiners should be aware of the characteristics of this financing technique and its potential effect on a bank's loan portfolio and overall financial condition.

GENERAL BACKGROUND

Although leveraged buyout arrangements may vary from case to case, they typically have a number of characteristics in common. Generally, each involves the financing of an acquisition of a company, or a subsidiary or division of a company, by a group of private investors and/or company managers. Normally, the investors or managers put up a relatively small amount of equity, borrow heavily against the company's assets and future cash flow and buy out existing owners or shareholders. Often at least a portion of the debt is secured by the assets of the acquired entity, generally accounts receivable or inventory. In particular, the financing arrangements usually include (a) senior debt, secured or unsecured, often provided by banks

and other institutional lenders and representing the largest share of the buyout financing; (b) subordinated debt and/or preferred stock in the form of paper taken back by the seller; and (c) common equity supplied by the new owners. Debt levels amounting to seven to ten times equity and more are not unusual in leveraged buyout situations. The viability of leveraged buyouts is predicated upon the strength, stability and future prospects of the earnings and cash flow of the acquired entity.

Once a company has been acquired in a leveraged buyout its assets and liabilities are revalued at market value. This usually results in a write-up of asset values, and, consequently, a higher amount of depreciation expense than before the buyout. These higher depreciation charges, coupled with the large interest expense deductions on the acquisition debt, reduce the taxable income associated with the purchased company and, therefore, reduce the income taxes that the company must pay. Most leveraged buyout companies pay little or no income taxes during the first few years after the transaction.

Banks participating in financing these arrangements often earn an up front fee of one tenth percent to one fourth percent while the agent bank may take an additional one fourth percent annually for monitoring the collateral and handling the paperwork. Banks have extended both secured and unsecured loans for leveraged buyouts in the form of revolving credits and term loans. These loans may carry a fixed or variable interest rate ranging from prime plus 1¼ percent to prime plus 2½ percent for senior debt and prime plus 3 percent at a minimum for subordinated loans. Some loans have been structured in such a way as to require the payment of interest only for the first two or three years following the buyout. In addition to these primary loan facilities, banks may extend ancillary lines of credit which may be drawn upon only for the payment of interest, usually when interest rates on variable rate primary loans exceed a certain pre-determined "cap" rate. While intended to provide the borrower some initial temporary protection from unfavorable interest rate movements and heavy debt service obligations, these arrangements could mask emerging debt service problems and postpone the timely recognition of potential credit weaknesses in a bank's loan portfolio.

SUPERVISORY CONSIDERATIONS

The nature of leveraged buyouts and, in particular, the level of debt typically involved in such arrangements give rise to supervisory concerns over the potential risk implications for bank loan portfolios. The high volume of debt relative to equity that is characteristic of leveraged buyouts leaves little margin for error or cushion to enable the purchased company to withstand unanticipated financial pressures or economic adversity. Two principal financial risks associated with leveraged buyout financing are: (1) the possibility that interest rates may rise higher than anticipated and thereby significantly increase the purchased company's debt service burden; and/or (2) the possibility that the company's earnings and cash flow will decline or fail to meet projections, either because of a general economic recession or because of a downturn in a particular industry or sector of the economy. While either one of these developments can undermine the creditworthiness of any loan, the high degree of leverage and the small equity cushion typical of most leveraged buyouts suggest that economic or financial adversity will have a particularly large and negative impact on such companies. Thus, a leveraged buyout arrangement that appears reasonable at a given rate of interest or expected cash flow can suddenly appear to be questionable if interest rates rise significantly or if earnings should fail to provide an adequate margin of coverage to service the acquisition debt.

In addition to unfavorable interest rate movements and earnings developments, adverse economic conditions may also have a negative impact on the value of a company's collateral. For example, if a general economic slowdown reduces a company's sales and earnings, the marketability and value of its collateral may also suffer. In any event, given the amount of debt involved in leveraged buyouts, the value of collateral is extremely important, and the risk that collateral coverage may be insufficient to protect the bank is a significant factor in evaluating the creditworthiness of these loans. In light of all of these considerations, the quality of a purchased company's management is also extremely important and represents another critical element in the bank's evaluation of leveraged buyouts. This is because such management must oversee both the special financial risks associated with the leveraged buyout form of acquisition financing as well as the normal day-to-day affairs and operations of the purchased company's business.

In the course of on-site examinations, examiners should review a bank's involvement in leveraged buyout financing as well as the loans associated with individual

leveraged buyouts. The following general guidelines are provided to underscore and supplement existing loan review procedures.

1. In evaluating individual loans and credit files, particular attention should be addressed to i) the reasonableness of interest rate assumptions and earnings projections relied upon by the bank in extending the loan; ii) the trend of the borrowing company's and the industry's performance overtime and the history and stability of the company's earnings and cash flow, particularly over the most recent business cycle; iii) the relationship between the company's cash flow and debt service requirements and the resulting margin of debt service coverage; and iv) the reliability and stability of collateral values and the adequacy of collateral coverage.

2. In reviewing the performance of individual credits, examiners should attempt to determine if debt service requirements are being covered by cash flow generated by the company's operations or whether the debt service requirements are being met out of the proceeds of additional or ancillary loans from the bank designed to cover interest changes.

3. Policies and procedures pertaining to leveraged buyout financing should be reviewed to ensure that they incorporate prudent and reasonable limits on the total amount and type (by industry) of exposure that the bank can assume through these financing arrangements.

4. The bank's pricing, credit policies and approval procedures should be reviewed to ensure i) that rates are reasonable in light of the risks involved and ii) that credit standards are not compromised in order to increase market share. Credit standards and internal review and approval standards should reflect the degree of risk and leverage inherent in these transactions.

5. Total loans to finance leveraged buyouts should be treated as a potential concentration of credit and if, in the aggregate, they are sufficiently large in relation to capital, the loans should be listed on the concentrations page in the examination report.

6. Significant deficiencies or risks regarding a bank's leveraged buyout financing should be discussed on page 1 of the examination report and brought to the attention of the board of directors.

This interim letter sets forth some general considerations and draft guidelines for use in reviewing leveraged buyouts. Reserve Banks are instructed to carefully review a bank's leveraged buyout financing activities and to forward comments and suggestions for modifying, expanding or strengthening these procedures as additional experience is gained in appraising these credits. Enhanced guidelines will be provided in the future. Comments or questions may be addressed to Richard Spillenkothen or Jerry Edwards.

JOHN E. RYAN, *Director.*

Chairman PICKLE. Now we ask Mr. George B. James if he will come to the witness table.

Mr. James, are you here in the room?

Mr. JAMES. Yes, sir.

Chairman PICKLE. Mr. James is the executive vice president and group president of the Crown Zellerbach Corp. We are glad to have you here today, Mr. James, and ask you to proceed.

STATEMENT OF GEORGE B. JAMES, EXECUTIVE VICE PRESIDENT, CROWN ZELLERBACH CORP.

Mr. JAMES. Thank you very much, Mr. Pickle.

My name is George James. I am executive vice president and group president of Crown Zellerbach Corp. I previously, for 2 years, was the chief financial officer of that company, and prior to that, for 10 years I was the chief financial officer with Arcata Corp., a major west coast forest products company.

I have a prepared statement that I would like included in the record, and I would like to make some comments apropos of that statement.

Chairman PICKLE. That will be agreed to.

Mr. JAMES. I very much appreciate the opportunity to appear before the subcommittee, because of the seriousness of the takeover

wave that is affecting not only corporate America, but natural resource base companies, and because Crown Zellerbach appears to be the first company to testify on the dangerous consequences of takeover raiding in the paper and forest products industry.

Regarding Crown Zellerbach, we are a 115-year-old company, with sales of approximately $3 billion. We are the seventh largest U.S. forest/paper company, fully integrated, that owns our own forests. We make wood products, we make paper, and we distribute our products.

We have approximately 23,000 shareholders throughout the country. We operate in 35 different States, with 50 production facilities, plus 70 distribution locations, and though we are headquartered in San Francisco, less than 5 percent of our employees are there. We have 19,000 employees, all over the country, and we are really based in those small communities where we operate.

Three years ago we had a new management team come into the company that began realigning it for long-term growth, building on some of our greatest strengths; these include a large, very productive timber base. We own 2 million acres of timberland in the country, 1 million acres in the Northwest, and 1 million acres in the South. In addition, we have large competitive manufacturing facilities. And we are in growing markets for our products.

We have developed, over time, technological skills, very able people in our company, and we have very high morale. We have trimmed down our company. We have refocused on our growth areas, and we have gone through some significant restructuring, all in the last 3 years. In the last 3 years we have spent $750 million to expand and modernize our facilities, and it is the largest capital program in the company's history.

As you gentlemen can understand, investments in our industry take time to pay off. We have developed real momentum as a company, as we proceed with what we think will be one of the best turnaround stories in the history of the forest and paper products industry. The complete commitment of our directors and management is to steady growth and shareholder value on a continuing long-term basis that is never sacrificed for short-term advantages, and I think, like the oil industry, which you have heard from, the forest products industry is a target for corporate raiders trying to seize their undervalued natural resources for far below their intrinsic value.

As I state on page 3 of my written testimony, five major companies in our industry have been recent takeover targets.

A 25-percent foreign investor in Scott Paper may increase his position when a standstill agreement expires at the end of this year.

Diamond International was liquidated by the same Anglo-French financier, Sir James Goldsmith, who now wants Crown Zellerbach.

Last year Champion International acted as a white knight for St. Regis Paper, which had exhausted itself facing two separate greenmail moves, one of them again involving Sir James Goldsmith, and the Continental Group was pushed by Mr. Goldsmith into the hands of a white knight, which commenced liquidation of the company.

Southwest Forest Products has been another recent target. Earlier, Evans Products was taken over by a well-known raider, and its stock has dropped from 24 to 2, and it is now in bankruptcy.

Now, the latest move is a tender offer for Crown Zellerbach, made last Wednesday, by interests controlled by Mr. Goldsmith. He now owns a little over 9 percent of our company, and this tender would give him between 50 and 70 percent.

How can all this happen? We think it is very simple. We have, and our industry has, undervalued assets. We would like to discuss all of this from the point of view of three stakeholders in the action: One is the raider; second is the target company with its employees in the communities in which it is based; and the third is the U.S. Government.

First, as to the raider's stake, the first point I would like to make is the quality of management is not the issue in the takeover movement. Compare the industry's management record with the record of raiders.

The Continental Group is now much smaller and heavily burdened with debt. Evans Forest Products, as I mentioned, is in bankruptcy, and with Diamond International, 1 day after Sir James Goldsmith's takeover was approved, both Standard & Poors and Moody's downgraded Diamond's debt from AA to BB values, from very strong to predominantly speculative in terms of his ability to pay not only the interest but the principal as well.

Then as reported in Fortune magazine of October 1983, what Mr. Goldsmith managed in the next 10 months was not improved operations of Diamond, but one of the largest liquidations of any U.S. company, and I quote: "He and a skeleton staff of three executives in New York have sold six divisions, and negotiated tentative deals for three others." All that is left of Diamond is 1.7 million acres of trees safely in Mr. Goldsmith's hands.

As set out on page 3 of my prepared statement, better management is not the objective of the raiders at all. They do not look for weak companies, they look for just the opposite, good ones whose assets are generally undervalued by the market. If they liquidate the target, their so-called restructuring expertise is really in liquidating these assets.

Thus, a speculator who took over Crown Zellerbach could liquidate, exactly as was done with Diamond. At the present time, undervalued assets are not unusual among natural resource companies. Crown Zellerbach is a good example of the difficulty of valuing forest products companies from time to time.

For example, in 1980 a leading security analyst valued our timber alone at $115 a share. Our stock at that time was selling at $42. In 1984 the same thing happened. Another analyst valued our stock at $60. The market was then selling in the low thirties.

Our oil and gas reserves, which we have under our timber lands, cannot yet be evaluated, and they increase this kind of uncertainty.

My point is that stock market prices very often do not give accurate estimates of the value of a company. If they did, the raiders would not exist.

Let us turn to the second stakeholder I mentioned, the target company itself. What is its stake in the situation? Well, for one

thing, employees' jobs are threatened. The well being of the community is threatened.

Should I continue, Mr. Chairman?

Chairman PICKLE. Yes; you may go ahead, Mr. James. We may have to leave for a vote. However, you can conclude your statement, so the members can leave as soon as they are needed.

Mr. JAMES. From the standpoint of the company, there is tremendous diversion of time and energy. And if the raider is successful, the effects of leverage on the target companies are substantial. The financial restructuring caused by the takeover raids creates no new assets, resources, or wealth. It merely shifts ownership and replaces equity with enormous debt at high junk bond rates. All earnings must be devoted to servicing the debt. The company is therefore saddled with all the problems classically associated with lack of capital, and the company spends most of its time fighting off the creditors rather than doing highly productive things.

In terms of the Government, I would like to make the point that the U.S. Treasury is greatly affected by junk bond financing which is used in most of today's hostile takeovers. The effect of junk bond financing is very significant in terms of national productivity, stock market volatility, and serious potential loss of tax revenues. The enormous junk bond debt soaks up money that could otherwise flow into equity capitol. There is evidence, for example, that savings and loans have been large buyers of these instruments, which diverts capital from home financing and into a high-risk investment instead.

Yesterday, it was reported in the Wall Street Journal that the Federal Home Loan Bank Board will consider restricting savings and loan investments in junk bonds.

I would like to turn quickly to stock market volatility, because is shows how a raid often takes place. Speculative pools are formed by the raider and his associates to carry out the raid. Stock purchases of the target company take place and a 13–D is filed. Stockholders expect the stock to rise and the company ends up getting put in play. This creates extreme volatility, putting uninformed minority shareholders at the mercy of the speculators. It is remindful of the manipulations in the so-called bull market and bear market raids of the twenties that led to the passage of the Securities Exchange Act.

Finally, I would like to comment on the tax implications because we strongly support H.R. 1100 and 1003, specifically to eliminate the deductions of interest on hostile takeover debt because it shelters the target company's income so heavily that it subsidizes the takeover, and because the junk bond debt really plays a role of equity in the capital structure, as reflected in H.R. 1100.

We feel that the increase in the basis of a target's assets should give rise to taxable gain. That is H.R. 1003, and we would go a step beyond H.R. 1003 and urge that no increase in the basis of the target's assets be allowed for the amount of tax paid on the increase in the target's base.

Unfortunately, we do not have the information necessary to advise the committee as to the exact relationship of these proposals to the complex web of interrelated tax haven based offshore enti-

ties from which Sir James Goldsmith operates. There is further reference to this in my prepared statement.

To summarize, Mr. Chairman, hostile takeovers have become a serious affliction on the Nation's economic well-being. The modern day corporate raider, far from keeping entrenched management on its toes, is draining vitality from our industrial base and replacing it with the poison of enormous new debt and surely posing new threats to the banking and credit system. If the affliction continues untreated, we will see the increasing erosion of America's industrial base, already suffering from the impact of foreign competition across a wide spectrum of the economy.

The laissez-faire attitude reflected in some testimony before several congressional committees during the last 2 weeks fails to acknowledge that corporate raiders are draining energy, skills, and time into takeover defenses, when those qualities should be concentrated on regaining and keeping America's competitive edge in the world economy.

The Congress in general and this committee are to be commended for acknowledging that a real problem exists and for holding these hearings. I hope you will proceed to enact legislation promptly in response to what you have heard during these hearings. It may or may not be in time to affect the outcome of my company in its current struggle, but you will have performed a significant public service if you can place a shroud over the gunsights that are now sweeping the American industrial scene for new targets on an almost daily basis.

[The prepared statement follows:]

STATEMENT OF GEORGE B. JAMES, EXECUTIVE VICE PRESIDENT AND GROUP PRESIDENT, CROWN ZELLERBACH CORP.

INTRODUCTION

My name is George James. I am an Executive Vice President and Group President of the Crown Zellerbach Corporation. I was previously Senior Vice President and Chief Financial Officer of the company, and held those same positions with Arcata Corporation, a major forest products company in the west, before joining Crown Zellerbach.

I want to thank the subcommittee for this opportunity to discuss with you the serious implications of the current takeover movement for our country, for thousands of employees and for hundreds of communities across the land, for shareholders, and for our industry in particular inasmuch as I believe I am the first representative of the paper and forest products industry to appear before Congress on this subject—certainly so, on the tax aspects.

Crown Zellerbach has grown, over a 115-year period, from a small San Francisco paper distributor to a $3 billion paper and forest products company that operates in thirty-five states. We have 19,000 employees who produce paper, packaging, plastic films, non-woven fabrics, corrugated containers, lumber and wood products at some fifty different facilities. They also distribute paper, related products, and computer supplies at some seventy distribution locations across the country, and they manage some two million acres of forestlands in the Pacific Northwest, Louisiana and Mississippi. Eleven members of the full committee have Crown Zellerbach facilities in their districts.

Last week our company became the subject of a tender offer made by interests controlled by the Anglo-French takeover financier, Sir James Goldsmith.

This comes at a time when out company is well into one of the major turnarounds in our industry. Based on policies approved by our board of directors three years ago, we have initiated major restructuring, we have trimmed down to a focused, highly efficient and innovative work force, and in other ways which I will describe we have committed our inherent strengths, skills, and large capital investments to programs which we are confident will produce exceptional value for our sharehold-

ers over the long-term. It is to steady enhancement of that value that our board and our management are dedicated. And even while a major turnaround takes time, and even in an industry that has had severe problems in this decade, Crown Zellerbach has already achieved solid successes. We have moved sharply upward in basic performance measurements against major peer competitors, and we have developed the forward momentum that is critical to moving still further ahead in terms of our relative competitive performance.

While some shareholders might gain a small, short-term premium in the course of the current takeover attack, the hostile takeover that has been proposed would interrupt this long-term momentum, would not reflect the inherent long-term value that shareholders should anticipate, and would be extremely hurtful to the many communities and the thousands of employees who are all part of Crown Zellerbach.

Because of this, and because other paper and forest products companies are probable targets, we commend the committee for directing its attention to this vital sector of the economy at this time.

Effects of hostile takeovers in the forest products industry.—Like the oil industry, the forest products industry is a target for corporate raiders exploiting undervalued natural resource companies.

Five major companies in our industry have been recent takeover targets. A 25 percent foreign investor in Scott Paper may increase his position when a standstill agreement expires at the end of this year. Diamond International was liquidated by the same Anglo-French financier, Sir James Goldsmith, who now wants Crown Zellerbach. Last year, Champion International acted as white knight for St. Regis Paper which had exhausted itself facing two separate greenmail moves, one of them again involving Sir James Goldsmith, and the Continental Group was pushed by Mr. Goldsmith into the hands of a white knight which commenced liquidation. Southwest Forest Products has been another recent target. Earlier, Evans Products was taken over by a well known raider, and its stock has dropped from 24 to 2 and it is in bankruptcy.

The purpose of takeovers, as seen by the raider.—"Better management" is not the objective of the raiders. They don't look for weak companies, they look for good ones whose assets are greatly undervalued, and their "restructuring expertise" is then in liquidating those assets. Is Diamond International, which was taken over by Mr. Goldsmith, a better managed company under its new "management?" As reported in Fortune Magazine of October 17, 1983, in the ten months following the acquisition what the raider "managed" was "one of the largest liquidations of a U.S. company. . . . He and a skeleton staff of three executives in New York have sold six divisions and negotiated tentative deals for three others." All that is left of Diamond is 1,700,000 acres of trees, and Fortune put the acquirer's profit at more than $500 million.

Thus, if a takeover raider is able to gain control of Crown Zellerbach at a large discount from the real value of the company to its stockholders, he could liquidate it as was done with Diamond International. This could be done by spinning off business units and splitting off plants that are now closely inter-related, as was done with Diamond, selling them piece by piece for a total price that would be well above his total cost so that he could pay off the junk bond debt which he would float to finance his raid. Remaining assets, or their sale, would represent his profit on the entire transaction, down to total liquidation if he chose.

Contrary to the Council of Economic Advisors' assertion that stock market prices give "accurate estimates" of the value of a company, the fact is that they very often don't. This would seem obvious, for otherwise there would be no raiding. Crown Zellerbach is a classic case of the difficulty of valuing assets in the natural resource industries.

Two security analyst studies in recent years showed the disparity between stock market price and value. One leading Wall Street analyst valued Crown Zellerbach in 1980 at $115 per share, based solely on valuing our timber alone at that price, compared to a stock market price then of $42. Last August a similar analyst study valued all Crown Zellerbach assets at $60 per share, when the market price was $33. As a further example, the valuing of large gas deposits discovered several years ago on our Louisiana properties awaits improved technology for the depths involved. Crown Zellerbach is constantly asked to lease acreage for exploratory drilling by oil and gas firms, including newly promising areas in the Pacific Northwest. We do this regularly, and there is no way of assigning a meaningful value today to the hydrocarbons that may be discovered in the future.

The stake of the stockholders, employees and communities of the forest products industry.—A raider tries to intimidate the target's board and stampede the target's shareholders. The pressure is then on management to devote time and energy to

dealing with the hostile takeover threat, which diverts them from running the business, from creating employment and from contributing their maximum benefits to the national economy. Crown has avoided being put in this position, but our management is still diverted.

The financial restructuring caused by these raids creates no new assets, resources or wealth. It merely shifts ownership and replaces equity with enormous debt at high junk bond interest rates as the corporation's financial structure is undermined. All earnings must be devoted to servicing the debt. The company is therefore saddled with all the problems classically associated with lack of capital: management flexibility and risk-taking are gone, no funds are available for plant and equipment investment, for expansion, or for research and product development, growth is precluded, the company's relative competitive ability declines, its productivity declines, morale declines, talented people leave, comparable talent cannot be recruited and loyal employees lose their jobs.

The operating results and financial standing of a number of the companies acquired by raiders through unfriendly takeovers have been worse under the new ownership than when independent. The Evans Products bankruptcy is a case in point in the wood products industry. The Continental Group is newly loaded with enormous debt. Only one day after approval of the acquisition of Diamond International by Mr. Goldsmith, Standard and Poor's and Moody's dropped Diamond debt ratings from double A to double B-minus, meaning from "very strong" to "predominantly speculative" in terms of ability to pay interest and principal. All in all, the effects are the opposite of the government's goal of reindustrializing America and increasing our national productivity. Generalized testimony about letting the "free market work" in order to accomplish that objective therefore does not seem applicable to takeovers, based on the record. In fact, reindustrialization appears to be one of the losers in the total process, along with the target company's creditors, employees, minority shareholders and the federal government, to whose stake in this subject I would like to turn at this point.

The stake of the government in junk bond financing of corporate raiders.—Because major effects of takeovers on the economy and on government policies appear to be intensified by the surge in junk bond financing, we will discuss them in that context.

Junk bonds are very low rated debentures that are heavily subordinated to creditors and other debt and that consequently hold out extremely high yields - as high as 20%. Enormous amounts of them are sold to finance takeover raids, solely on the premise that the target company's assets would be liquidated to the extent required to pay off these debentures. The investment banking commission on junk bond underwritings—reportedly three to seven times higher than on investment grade bonds—creates an extreme marketing incentive. But the investment bankers who market junk bonds have no obligation to our shareholders, nor to the communities where we operate. The financing done, they leave the raider to deal with these constituencies. Professor Edward Altman of the New York University Graduate School of Business estimates that low-rated, public non-convertible debt quadrupled in six years from about $10 billion in 1978 to about $42 billion in 1984, when he estimates that it represented more than 11 percent of the total corporate debt market versus less than 4 percent in 1978.

One concern for the government is that this enormous junk bond debt soaks up money that could otherwise flow into equity capital and therefore into improved national productivity. There is evidence, for example, that savings and loans have been large buyers of these instruments, which diverts capital from home financing and into a high risk investment instead.

The decline in productivity of debt-ridden companies, described above, can also have significant implications for the international competitive strength of our nation. Addressing this issue, Professor Thurow of M.I.T. has made the following observations. The English speaking nations—the United States, Canada, Great Britain, Australia, and New Zealand—were the five worst among the 20 worst performing significant economies over the past 20 years, and in the five years from 1978 through 1982, the United States lagged behind all its major competitors—France, Japan, Italy and Germany—in productivity gains. They ranged from gains of 2.1 percent to 3.6 percent. Ours was .5 percent. He adds that our reinvestment in plant and equipment is running at half the rate of that of Japan and only two-thirds that of Europe.

Our laws should not encourage junk bond financing that promotes hostile corporate takeovers and liquidations that can further these effects. The implications for our economy in terms of research and development, reinvestment in plant and equipment, and the other great forces for improved productivity and reindustrializa-

tion are profound, and it is the large American corporations, built over many decades into the principal wealth creating forces of the American economy, that provide the greatest of these forces and thus function as the offset to the central economic planning agencies of our major competitor nations. The role of these corporations in the international competitive effectiveness of our economy should not be fragmented or otherwise weakened, it should be strengthened.

An additional matter of concern for the government is the stock market volatility that appears to be triggered increasingly by junk bond financing. Speculative pools are formed by the raider and his associates to carry out the raid. His associates can include large institutional investors, which dominate and make today's stock markets. And even when not acting consciously in concert, the same effect results from an index or other computer-programmed fund that is set to sell at given prices without regard to other considerations.

Stock purchases of the target company take place and a 13-D is filed. Because stockholders then expect the stock to rise, speculation by arbitrageurs and other short-term investors helps the raiding group drive up the price. This creates extreme volatility, with uninformed minority shareholders at the mercy of the skillful speculator. It is remindful of the manipulations in the so called bull market and bear market "raids" of the 1920s that, with other abuses, led to the passage of the Securities Exchange Act of 1934, intended as a force for market order, stability, and openness. One would think that market activity of this type would be anathema to some of the government witnesses who have provided you with testimony favorable to the takeover movement. We should remember that the greatest surge in junk bond financing has occurred in a period of overall economic growth. As we move through several economic cycles we believe that junk bonds will be exposed as risky financial vehicles, often created to bring profit to raiders and to those investment bankers whose concern is not the financial security of the investor.

Revisions in the Internal Revenue Code proposed by HR. 1100 and HR. 1003.—The third area of governmental concern that we wish to address is the sizeable potential for lost tax revenues. In light of our expressed concern over the level of hostile takeover activity, the attendant human and economic dislocation and the increasing use of debt in those acquisitions with all the implications debt financing has for corporate economic health, we strongly favor tax legislation that will deter inefficient and non-consensual changes in corporate control. In our view, those provisions of the Internal Revenue Code that subsidize raiders by permitting deductions for interest on hostile takeover "debt" and that permit the untaxed increase in the basis of corporate assets in the hostile takeover context, should be amended along the lines embodied in HR.1003 and HR.1100 introduced by Representative Jones.

The emerging form of hostile takeover financed through the issuance of subordinated indebtedness is of particular concern. By raising the debt-equity ratio to totally unsound financial levels, this pernicious practice effectively shifts the downside risks of the target's business from the very small equity cushion to the subordinated debt holders. From the standpoint of creditors and senior debt holders, the subordinated debt serves the same economic purpose as equity in that it insures the repayment of the unsubordinated and senior debt.

Further, since current tax law does not appear to prevent any substantial risk of interest expense disallowance, absent "equity" features such as convertibility, the ability to issue unsubordinated "junk bonds" in hostile takeovers provides a virtual license to eliminate totally the corporate income tax liability of the target company. Through this device the loss of tax revenues becomes an effective subsidy for the raider.

Accordingly, in our view, Section 2 of HR.1100 would treat "junk bonds" issued in hostile takeovers in a manner consistent with their economic status as risk capital.

We also endorse those provisions of HR.1003 that would make the present election under Section 338 of the Internal Revenue Code mandatory in the case of stock purchases pursuant to a hostile takeover and would make Section 337 unavailable in such circumstances. These amendments would insure that any step-up in the basis of the target company's assets would give rise to taxable gain and would insure that the tax attributes of the target corporation would be extinguished. Going one step beyond HR.1003, we would also recommend that no increase in the basis of a target's assets be permitted for the amount of tax paid on the step-up.

With the foregoing changes a degree of neutrality will be restored to the tax law which is presently threatened with massive subversion from hostile takeovers.

We urge these tax law changes, fully realizing the legislative difficulties, because we doubt that Williams Act recourse can stop this unhealthy epidemic of hostile takeovers and something must be done. Clearly, such activity should not be aided and abetted by the unintended benefits of existing tax law.

However, without desiring to divert the Committee's attention from the critical legislative proposals before it, we confess that we do not know whether enactment of this legislation would inhibit Mr. Goldsmith and his complex web of tax-haven based, off-shore entities since we are not sure whether he and they pay or will pay United States income taxes. The principal companies reported to be holding shares in Crown Zellerbach are a Cayman Islands company and a Netherlands Antilles company. A majority of the Cayman Islands company is owned by a Panamanian corporation. A Lichtenstein foundation and Mr. Goldsmith own the stock of the Panamanian company. The Netherlands Antilles company is in turn owned by a Hong Kong corporation. One can only wonder with such a corporate structure how much of the gains generated by an ultimate liquidation process will escape taxation.

This concludes my prepared statement. I would like to thank the committee again for the opportunity to appear and I urge your earliest legislative action on HR. 1003 and HR. 1100.

Chairman PICKLE. Thank you, Mr. James.

Tell me again what is the status of Crown Zellerbach? You said a tender offer was made last week. Is that last week now or last month?

Mr. JAMES. A tender offer was made last week. The tender offer expires on May 7, which is 2 days before our annual meeting.

Chairman PICKLE. When will that be?

Mr. JAMES. May 9.

Chairman PICKLE. And here you are a company with good assets, paying taxes, healthy, valued at some $3 billion, and now you are a target of takeovers.

Mr. JAMES. Right.

Chairman PICKLE. Within the next 30 to 60 days?

Mr. JAMES. Yes. We are a target of a tender offer at $42.50 a share which we think is vastly lower than the true value of our underlying assets.

Chairman PICKLE. I presume the essence of your testimony would be that you support, we will say, H.R. 1100 which specifically suggests that we do something about the deduction of interest and that part of the law that permits an increase in the basis of corporate assets.

Mr. JAMES. That is correct.

Chairman PICKLE. Essentially the Jones bill?

Mr. JAMES. The Jones bill, that is correct.

Chairman PICKLE. I also presume when you gave the example of what was left of Diamond Co. after Mr. Goldsmith had taken over the company, they began to liquidate it and all that is now left of Diamond is 1.7 million acres of timberland while the acquirer, Sir James Goldsmith, has made some $500 million profit, that you are trying to keep that from happening to your company.

Mr. JAMES. That is correct. That was reported in Fortune magazine that he paid off all the debt he used to acquire the company by selling off its assets and was left with the trees.

Chairman PICKLE. I suppose then what is really your problem, is that some experts say that these firms are vulnerable if the stock is undervalued, that the corporation is high in Federal tax liability, large cash assets, and perhaps overfunded pension plans.

Do you have an overfunded pension plan?

Mr. JAMES. We have a pension fund that has more assets in it than are currently needed to serve our employees, but it is not overfunded to any great degree.

Chairman PICKLE. Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

I wanted to inquire about two specific areas, and so I will be very brief in my questions and hope that perhaps your response would also be brief in the interest of time.

I am interested in the poison pill, the reasons why your company developed this strategy, and do you feel that this inhibits any ongoing activity of your company?

Mr. JAMES. In terms of the poison pill defense that we adopted, the reason for adopting that was to give the board cf directors sufficient control over dealing with an unfriendly acquisition attempt because we knew the company had greater values than were reflected in the stock market. It gave the board an ability to deal with a raider. The raider would have to deal with the board in making any tender offer.

No; it has not restricted to management's activities. In fact, it has enabled us to go about our business of running the company and trying to improve on shareholder values. That was up until the time that Mr. Goldsmith launched his unfriendly attack and then, of course, our energies were diverted to defending against him and trying to make sure that our shareholders get the values to which they are entitled and not have Mr. Goldsmith raid the company, do what he did with Diamond, sell off assets, and deprive the shareholders of what they should have.

Mr. FLIPPO. Since Mr. Goldsmith, I believe, is a British industrialist, can you give us any better understanding about how the U.S. Tax Code works when you have a foreign entity? In other words, does the U.S. Tax Code give foreign persons some tax incentive that is not available to U.S. persons in the area of mergers? Can you help us understand that?

Mr. JAMES. I am sorry that I am not a tax expert and I cannot shed an awful lot of light on that. I can only reflect that in Mr. Goldsmith's case all of his—I will not say all of it—most of his companies used in these takeovers are offshore companies that are based in countries and areas that are tax havens, and I am not sure how all of this legislation that is pending will affect Mr. Goldsmith And I think the committee should really look into the cases where foreign hostile raiders are getting involved in the United States because I am sure that one of their objectives is to reduce their tax liability to nothing or close to it.

Mr. FLIPPO. One of the problems, as you have heard in the testimony this morning, is that many members have difficulty with a hostile takeover. It is a matter of great concern.

Could you offer any better definition that one might use to distinguish between the economics of a hostile versus a friendly?

Mr. JAMES. Well, first off, I do not believe that all hostile takeovers are necessarily bad. In some cases I think, as pointed out by Mr. Martin and others, hostile takeovers can help shareholders realize the values when they have inept or lethargic management. What we are concerned about is hostile takeovers that are done with junk bonds, because that does not give a level playing field to all the players involved. So it is the combination of a hostile takeover that is facilitated by junk, high-risk bonds that concerns us.

I think the definition in the Jones bill is a good one, a majority of the independent outside directors of a company making that de-

termination. In our case we have three-quarters of our directors who are outside independent directors, many of them formerly chief executives of their own companies. They were appointed by a board committee composed of outside directors who themselves are independent, and I would say they are recommended by that committee and approved by the whole board so they do have independent status. None of them have an ongoing stake in the company as an officer or a manager. So they are in a position to make the determination of what is best for the shareholders, and they can and could make a determination of what is a hostile takeover. I think that solution is a good one.

Mr. FLIPPO. My time is up, Mr. Chairman. Thank you.

Thank you, Mr. James, for your response.

Chairman PICKLE. Mr. James, will you pull one of those microphones over to you, either one of them? One of them is on your right shoulder and one is on your port bow. Take any one and put it closer so we can hear you.

Mr. Schulze.

Mr. SCHULZE. Mr. James, you spoke in generalities about the poison pill. Would you be more specific concerning the poison pill that Crown Zellerbach has prepared. Could you also explain how it was done and why it was done, what you anticipate the effect will be?

Mr. JAMES. Well, we became concerned, as I pointed out before, that the company might be raided by a hostile party.

Mr. SCHULZE. When was this?

Mr. JAMES. This was approximately a year ago when we began looking at it. We consulted with our outside investment bankers, Solomon Bros. We consulted with our attorney, Martin Lipton, and they have designed this takeover defense called the poison pill.

Basically it enables the shareholders, in the case when an outside party gets at least 20 percent of the stock or makes an offer for 30 percent of the stock, to buy shares in the merged company for half its value. In other words, most takeover artists do a transaction in two steps. They initially buy stock in a company and then they merge that company into a shell corporation, and in that second transaction they really get their hands on the company's assets, and they need to take the second step in order to repay the debt that financed the first step.

The second step of this merger into the shell corporation is when the poison pill takes effect because it allows the shareholders of Crown Zellerbach, in this case, to buy stock in that newly merged company for half its appraised values.

Mr. SCHULZE. You say it allows?

Mr. JAMES. They have a right to.

Mr. SCHULZE. But they do not have to exercise that right.

How is that right exercised?

Mr. JAMES. In the case of a public corporation, of course, the value of the stock would be easily determinable. In the case of a private company, then there would have to be an appraisal procedure.

Mr. SCHULZE. What I am trying to get to is what specifically Crown Zellerbach lined up. In other words, if an individual or an

entity acquires 15 percent of your stock, does that trigger an action?

Mr. JAMES. No. The right is triggered when a person offers to buy 30 percent of our stock.

Mr. SCHULZE. Offers to buy?

Mr. JAMES. Offers to buy. It only becomes effective when the acquisition of 20 percent of the stock is completed. At that point the right is effective and the shareholder has that right to purchase stock in the merged company.

Mr. SCHULZE. Let us go over it once more.

What does the offer to buy have to do with the acquisiton? You say it is triggered when an individual or an entity has successfully purchased 20 percent of the outstanding stock.

Mr. JAMES. That is correct.

Mr. SCHULZE. Does that have to be in conjunction with an offer to buy the additional 8 percent or 9 percent?

Mr. JAMES. No; it does not. It is in effect when a third party has 20 percent of the stock and it says that if he takes the remaining part of Crown Zellerbach and merges it into a shell corporation, then the shareholder can buy stock in that new corporation at half its value, and that serves as a deterrent to take that second step.

Mr. SCHULZE. If Crown Zellerbach were merged in this instance, what would the actual effect be?

Mr. JAMES. The shareholders who retained rights would be able to exercise those rights and buy stock in the new corporation for half its appraised value. We do not expect that will happen.

Mr. SCHULZE. How is the appraised value determined and what effect will this have on the officers of the existing corporation?

Mr. JAMES. Well, in the first place——

Mr. SCHULZE. I guess what I am also getting at, does this just help the upper echelon officers, directors, and so forth?

Mr. JAMES. No, not at all. It really has no effect——

Mr. SCHULZE. Does it aid the average stockholder? What does it do for the people whose money is in the pension funds and so forth?

Mr. JAMES. The point of the poison pill is to serve as a terrific deterrent to anyone merging the company into a shell corporation. The economic consequences would be so severe that they would not do it.

Mr. SCHULZE. Suppose I thumb my nose at that and say I am not going to do it? What says I have to do it? Suppose I quickly have a meeting of the board, and we say now we have changed the rules?

Mr. JAMES. Well, the board has the right to call the rights in for 50 cents a share and, in fact, would do that if it agreed to a merger with a friendly party or any party it worked a transaction out with. In other words, the board, prior to the time somebody acquired 20 percent, could call those rights in and in fact would call those rights in, and they would have no effect, and then the board could make the determination that is in the total best interest of the shareholders. It really has no effect on the management. The effect is on the shareholders of the corporation.

Mr. SCHULZE. The management does not hold larger amounts of the stock than the general shareholders?

Mr. JAMES. No. Management has a fairly insignificant position in Crown Zellerbach stock.

Mr. SCHULZE. My time has expired. Thank you, Mr. Chairman.

Chairman PICKLE. For my information, have junk bonds been used with the company that attempted to take over Crown Zellerbach?

Mr. JAMES. It is our understanding that Sir James Goldsmith has used junk bonds in his dealing with other companies.

Chairman PICKLE. But you do not know whether it has been involved in your situation?

Mr. JAMES. As of right now, Drexel Burnham, who are the experts in junk bonds, are named as the dealer-manager in his tender offer, so we have to assume that they are involved.

Chairman PICKLE. That is right.

What percentage of stock does Sir James Goldsmith own in Crown Zellerbach now?

Mr. JAMES. He has about 9.3 percent, Mr. Chairman.

Chairman PICKLE. 9.3?

Mr. JAMES. Yes.

Chairman PICKLE. Mr. Frenzel.

Mr. FRENZEL. Thank you, Mr. Chairman.

Mr. James, we are delighted to have you here today. Are you testifying in favor of Mr. Jones' bill?

Mr. JAMES. Yes.

Mr. FRENZEL. And you believe that legislation would insulate Crown Zellerbach's stockholders from an unfavorable acquisition?

Mr. JAMES. We feel that it would cause a road roadblock in the event of what we are facing, a hostile takeover that appears to be financed with junk bonds.

Mr. FRENZEL. When you were describing to Mr. Schulze the second step of a hostile or a raider-type operation, that second step is necessary if the new owners are to convert their debt to corporate debt, is that correct?

Mr. JAMES. Yes; and get their hands on the assets of the acquired target company.

Mr. FRENZEL. When you adopted that policy, did the stockholders vote for it?

Mr. JAMES. The poison pill was determined by the board of directors and the shareholders did not vote on it.

Mr. FRENZEL. And the directors determined that that was in the best interest of the stockholders?

Mr. JAMES. Yes, they did, and that did follow on the heels of several antitakeover measures that the shareholders did vote for previously.

Mr. FRENZEL. Are you satisfied with the definition of greenmail, outside directors, and hostile takeovers contained in the Jones bill? Do you think it might be improved somewhat?

Mr. JAMES. I am satisfied with the definition of greenmail. I think it is a good one and I think that the Jones bill does approach the problem of defining a hostile takeover about as well as anyone has thought of. I do think that one problem is how do you link the hostile takeover and the junk bonds together in a way that serves to protect companies from being raided. And I think one of the things that ought to be studied in the future is the proper use of

leverage in takeovers because of the junior debt that is used in takeovers really has the attributes of equity, and that should mean that interest on some of the junior debt in takeovers should not be deductible interest.

But I think it is the combination of the junk bond and the hostile approach that most concerns us, and we think the Jones bill does address this, and in its present form.

Mr. FRENZEL. Do you think all hostile takeovers are bad?

Mr. JAMES. No.

Mr. FRENZEL. Do you think we need a better term then for determining that which we would not like to sanction or that which we would like to make more difficult?

Mr. JAMES. I do not think we need a better term because it really describes what is going on. I believe that the independent directors of a board, particularly are in a good position to determine what is hostile to the shareholders' interests and what is not.

Mr. FRENZEL. Does your firm have independent directors?

Mr. JAMES. Yes, we have a majority of independent directors, many of whom have been chief executives of major public corporations.

Mr. FRENZEL. What is an independent director?

Mr. JAMES. It is a director who does not have any current management responsibilities with the company, who in most cases is either a professional or a business person affiliated with another corporation with no ongoing responsibility

Mr. FRENZEL. Might he be affiliated with an organization that is a supplier or customer.

Mr. JAMES. In most cases, suppliers and people who represent concerns with whom you do business do not make good directors because the potential conflict of interests exists.

Mr. FRENZEL. How about lawyers and bankers, would they not qualify as independent directors if their organizations did business with the corporation?

Mr. JAMES. Well, they would qualify as independent directors because bankers and lawyers are professionals who deal with many corporation and subscribe——

Mr. FRENZEL. Even if they are making money from the corporation?

Mr. JAMES. In our case we do not have any commercial bankers or outside lawyers on our board. Some companies do and operate very well.

Mr. FRENZEL. Mr. James, we appreciate your testimony. Thank you very much.

Mr. JAMES. Thank you.

Chairman PICKLE. Mr. James, the independent directors are those who have no official capacity with the company?

Mr. JAMES. Correct.

Chairman PICKLE. But they are selected by management, is that correct?

Mr. JAMES. No. I think you will find, Mr. Chairman, that in most cases independent or new directors are recommended by a special board committee that would seek to find qualified directors, and then the board committee usually made up of independent direc-

tors itself would recommend new directors to the full board. That is the usual procedure in most businesses.

Chairman PICKLE. They may be selected by a committee or through a committee and then recommended to the full board.

Do the stockholders then vote in confirmation of that recommendation or selection?

Mr. JAMES. Yes, they vote at the annual meeting to appoint the directors.

Chairman PICKLE. But essentially if a committee recommends to the board and the board recommends to the shareholders the independent directors, the stockholders in nearly every instance will approve that, I assume, do they not?

Mr. JAMES. Yes, that is correct.

Chairman PICKLE. Well, Mr. James, we thank you very much for your testimony.

Mr. Anthony.

Mr. ANTHONY. I have just a few of questions. I would like to welcome Mr. James before the committee. In hearing your discussion with other members in support of the Jones legislation, what is it in your viewpoint and the board's viewpoint of Crown Zellerbach that says that this one is hostile, but yet another one would not be hostile?

Mr. JAMES. I think you have to use the criteria of whether it is in the best interests of the shareholders.

Mr. ANTHONY. Now, in your testimony, you say that if somebody takes it over, they could spin off all of the assets and would receive a greater amount of money. Taking a case example where the raider made over $500 million profit, would the stockholders not benefit in this case even in the short term?

Mr. JAMES. No. In that case, the shareholders have been sold out of the company. They have been paid off. The raider then gets control of the assets and sells them for his own account. The shareholders are closed out of these transactions. That is the problem. They do not realize the full value of their assets because their stock is sold, and in most cases it is a two-step transaction. The stock is sold in the tender offer and then there is a subsequent merger where they get either stock or cash and they are out of it, and the raider goes on to spin off the assets and sell everything for his own account. The raider really deprives the shareholders from values that are rightfully theirs.

Mr. ANTHONY. So, the board in its deliberations is more concerned in what is good for the shareholders instead of having the management displaced.

Mr. JAMES. Yes. We think the underlying value of the assets in Crown Zellerbach is substantially more than the raider is seeking to pay. And if he can pay the lower amount, he will load himself up with debt to the extent that he will almost be obliged to begin selling off the assets and ultimately liquidating the company and, in that way, repay his debt and make the profit he is looking for.

Mr. ANTHONY. Of the moves the board has taken, the poison pill and others, I read where you are even talking about putting the timberlands in a trust——

Mr. JAMES. Yes.

Mr. ANTHONY. Are you moving forward on it?

Mr. JAMES. We are looking at that, yes, right now.

Mr. ANTHONY. You are examining it right now?

Mr. JAMES. Yes.

Mr. ANTHONY. Is there anything that has been done because of the actions taken recently that would inhibit the future ability of the company to engage in its normal transactions?

Mr. JAMES. Yes. There is no question but that the presence of Mr. Goldsmith on the scene has disrupted things. For example, the two credit agencies both put us on the credit watch a couple weeks ago, and that might inhibit us borrowing money at normal rates. They put us on the credit watch because of the presence of Mr. Goldsmith and the uncertainties that that raises. So it does inhibit the company's action and, of course, internally you have workers all over the company wondering what is going on, wondering whether their mills are going to be closed down, and certainly not tending to business as they would like to do.

Mr. ANTHONY. Thank you.

Chairman PICKLE. Mr. James, could your company, Crown Zellerbach, actually liquidate assets, if that is a problem? If you did not want to go this other route, why do you not liquidate it yourself?

Mr. JAMES. That would be an altherative, Mr. Pickle, that I am sure the board will look at as we go down the road of this proxy fight.

Chairman PICKLE. If you reach that point.

Mr. JAMES. Yes. Our feeling all along has been that properly managing the assets we can bring the shareholders a much greater long-term retorn, following that course of action.

Chairman PICKLE. If you are interested in protecting the shareholders, you could liquidate and take that course, but I presume you are trying to avoid that course, is that essentially correct?

Mr. JAMES. Yes. We do not think that liquidation would provide the highest value for the shareholders. One of the big problems, Chairman Pickle, is the depressed conditions in the wood product industry, and the fact that the timberlands do not have the values they once had.

We think the values of timberlands will come back, and over time they will be a substantial asset for the shareholders. If you had a forced liquidation today of timberlands, they would not get the best values.

[The following was subsequently received:]

COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC, May 13, 1985.

MR. GEORGE B. JAMES,
Executive Vice President, Crown Zellerbach Corp., Washington, DC.

DEAR MR. JAMES: Thank you for appearing as a witness at the Subcommittee's hearing on mergers and acquisitions. Your experience and expertise provided the Subcommittee with much valuable analysis and information. For the purpose of completing the Subcommittee's hearing record, I have enclosed a series of additional questions for your response.

I would appreciate your review and response to my office by May 24, 1985. If you have any questions, please contact Bill Cunningham of the Subcommittee staff at 225-5522.

Sincerely yours,

J.J. PICKLE,
Chairman, Subcommittee on Oversight.

Enclosures.

1. Do you feel that the tax laws encourage mergers? If so, which provisions are primarily used by the parties involved in mergers? Should the tax code be neutral toward mergers? If yes, which provisions of the tax code should be changed and how?

2. Some experts argue that a firm is vulnerable to a takeover when (1) stock is undervalued in relation to its underlying assets; (2) the corporation has a high effective tax rate; or (3) the corporation has substantial liquid assets, including an overfunded pension plan. To what extent have any of these factors been involved in the merger activities of your company?

3. Some experts argue that the tax laws encourage debt financing rather than equity financing since corporations are allowed deductions for interest payments but not for payment of dividends.

(a) Do you agree?

(b) Should the Congress restrict or eliminate the deductibility of interest (1) generally; (2) in all mergers; (3) in "hostile takeovers"; or (4) for "junk bonds"? Please explain.

4. If a line were to be drawn for tax purposes between friendly mergers and hostile mergers, how should hostile be defined? Should a vote by the "independent directors" of the target corporation be determinative? If not, what test or standard should we use? Should the tax code distinguish between hostile and friendly mergers?

5. Have "junk bonds" been utilized in any mergers or attempted takeovers involving your company? If so, to what extent?

6. Have junk bonds been used to raise capital by your company? If so, to what extent?

7. If the deduction for interest payments on junk bonds were denied, do you feel that such denial should apply:

(a) To all junk bonds;

(b) To junk bonds used in connection with any merger or acquisition;

(c) To junk bonds used by any target company to repurchase its own stock?

Please explain your answer.

8. When junk bonds are used by a potential acquiring company, is the security for that financing usually the assets of the target company? If the lenders look to the assets of the target, is there an expectation that certain assets will be sold to service the debt? What would the beneficial and detrimental results of such sales be?

9. How would you define a "junk bond"? Are there other debt or equity instruments with similar characteristics to those of junk bonds that we should be concerned about in evaluating the deductibility of interest?

10. Does the election under Section 338 of the Internal Revenue Code to step up the basis of assets cause mergers to happen or does it instead influence the form of the merger?

11. What impact would a repeal of the Section 338 election have on mergers? Would it decrease the number of mergers and/or affect the terms of some mergers such as pricing?

12. Some experts argue that certain mergers are driven by profitable corporations seeking to offset their income by acquiring firms with net operating losses.

(a) In your experience, has the existence of NOL carryovers been involved in any mergers activity involving your company?

(b) Should consideration be given to limiting or increasing the transferability of NOLs in mergers?

13. There have been recent reports that managements of some target corporations are using Employee Stock Option Plans (ESOP) as a defensive takeover tactic.

(a) Is the use of an ESOP as a defensive takeover tactic consistent with the Congressional intent for such plans?

(b) What problems of employees in such situations should be of concern to us?

(c) Have ESOPs been used or discussed in any of the mergers with which you are familiar? If so, what were the circumstances and what were the results?

14. Has your company made greenmail payments or been asked to make such payments?

15. Should greenmail payments be prohibited or penalized? If so, should such regulation be done through the securities laws and/or the tax laws?

16. Should corporations making greenmail payments be allowed to deduct those payments in whole or in part as ordinary and necessary business expenses? Has your company taken or proposed to take such deductions?

17. Do you feel that forest and paper products companies have been focussed on by acquiring companies as attractive takeover targets in recent months? If so, why?

18. What effect has the recent surge in acquisitions and attempted acquisitions had on the forest and paper products industry? If you feel that this acquisition activity has had any negative impacts, please explain.

19. Do you feel that all acquisitions are bad? If not, do you feel that all "hostile" acquisitions are bad? If so, why? If not, what is it about the recent merger activity which is of concern to you?

20. What would you consider to be an acceptable debt/equity ratio for your company? Is this typical for the forest and paper products industry? At what debt/equity level would you consider your company to be in jeopardy? Hypothetically, do you feel that increasing your company's debt/equity ratio in the course of fighting a takeover attempt is justified? If so, why?

21. The offer made by the British industrialist, Sir Goldsmith, for your company was issued by CZC Acquisitions Corporation, a Delaware Corporation, which is wholly-owned by General Oriental Securities Limited Partnership, a Bermuda partnership of Sir Goldsmith.

(a) Do you think that the acquisition of U.S. companies by foreign corporations for foreign owned entities is increasing? If so, why? If so, is this something about which the Congress should be concerned?

(b) Does the tax code provide foreign persons with any tax incentives which are not available to U. S. persons in the area of mergers?

RESPONSES OF GEORGE B. JAMES

1. As stated in my testimony, interest on junk bonds used to finance hostile takeover raids should not be deductible. Deductibility encourages such raids and makes them posible, hence the Code as it stands is not neutral. We support all provisions of the Jones bill, H.R. 1100.

2. My testimony dealt at length with situation (1). Situations (2) and (3) do not apply to Crown Zellerbach.

3. (a) Yes. (b) (1) No; (2) no; (3) yes; (4) yes – see my testimony.

4. By vote of the independent directors, which should be determinative. Can also specify minimum percentage of stock held by the raider. The Code should distinguish as provided in H.R. 1100.

5. They are part of the financing plan of the Sir James Goldsmith interests. See SEC Schedule 14DC-1 filing of CZC Acquisition Corp., Amendment No. 2. We do not know whether they have been issued as yet.

6. No.

7. (a) No. (b) No; only in hostile takeover raids. (c) No.

Comment: It is the use of junk bonds to finance the hostile acquisition of assets that are undervalued by the stock market that is objectionable, because they lead to a debt load that can be serviced and retired only by partial or total liquidation of the company. The result is loss of a productive entity in the economy, loss of jobs, and frequently serious losses for individual investors.

8. Ultimately, yes. See answer to question 7.

9. By the lowest, or very low, credit ratings of accepted rating bodies (e.g. Moody's, Standard and Poor's)

10. Primarily, it is one of the incentives for mergers. Some would not happen otherwise.

11. Mergers would be fewer and at lower acquisition costs.

12. (a) Not to my knowledge. (b) No.

13. (a) Yes. An employee ownership stake was seen as an important incentive to increased productivity, competitive vigor, and employment stability. One of the reasons for ESOPs was to promote employee participation in the ownership of their employer as a competitively effective *continuing* entity that plays a meaningful role in our national economy. Companies taken over in hostile takeover raids frequently do not continue in that posture. They are liquidated, and jobs are permanently lost.

(b) Possible conflict between the fiduciary responsibilities of the ESOP trustee and the immediate interest of the employees in their job security, in the face of a successful raider's liquidation tactics, should be avoided or shielded.

(c) No.

14. No.

15. Yes, through both. They should be flatly prohibited, or made so onerous for the greenmailer that the tactic will die out.

16. Yes. No.

17. Yes, because the inherent value of their natural resource assets is not reflected in stock market prices which are largely determined by institutional and other money managers operating from a short term perspective. Targets have included

Continental Group, Diamond International, Evans Products, Scott Paper, St. Regis, Southwest Forest Products.

18. The thrust has been toward less expansion, more plant closures, retrenchment, loss of corporate momentum overall, diversion of management time and energy from operating responsibilities to defensive measures, and financial loss to many individual stockholders in hostile acquisitions.

19. No. No. My primary concern is the combination of junk bond financing (with the risks it poses to buyers of the bonds) and so loading the target company with debt that the operation cannot continue, thus requiring the liquidation of the assets to pay the debt, with all proceeds from the remaining assets accruing to the successful raider. He destroys the company, deprives its employees of their jobs, wreaks havoc in their communities, and keeps for himself the latent value that lay behind the stock and that ultimately would have accrued to the stockholders but for his attack.

20. Roughly one to two. This is probably a rough average for the forest products industry, with some as low as 20 percent debt and some above 40%. Four to one would pose very serious issues for Crown Zellerbach. Increasing our debt in a defensive fight can be justified because we would expect to continue the operation of the company. Since I testified, the Goldsmith interests have acknowledged to the media that they seek control in order to operate *"or liquidate"* the company (emphasis mine).

21. (a) The evidence of the daily press is that they are. This should be of great concern to the Congress because the use of offshore tax havens probably results in the loss of tax revenues which the Treasury would otherwise receive, and these can be very large. This means the American taxpayer subsidizes the liquidation of American businesses and destruction of American payrolls by individual foreigners solely for their own individual, private gain.

(b) We have not been able to trace the flow of funds through the numerous Goldsmith entities or shells based in foreign tax havens, but we assume that the Code must give the foreign raider advantages not available to a citizen of the United States. Congress has the resources to investigate this and should do so fully.

Chairman PICKLE. I see.

All right, we thank you, Mr. James, very much for your testimony.

Now I will ask Mr. William S. McKee and Mr. Martin Ginsburg, if those two gentlemen will take the position at the witness table.

Mr. William McKee is a partner in King & Spalding here in Washington, DC.

Mr. MCKEE. Yes. Mr. Pickle, if possible, we would like to have Professor Ginsburg start off, because my remarks follow his, and I think it would be more profitable to do it that way.

Chairman PICKLE. Professor Ginsburg is a professor of law at Georgetown University Law School.

I want to thank you at the beginning for your cooperation when we had a hearing some 10 days ago, 2 weeks ago. You were kind enough to come today because of the length of our last hearing. We appreciate your coooperation, and we are sorry that this is a little bit slower today, but at least you are here, and we are pleased that you are here.

Professor Ginsburg.

STATEMENT OF MARTIN D. GINSBURG, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW SCHOOL, WASHINGTON, DC

Mr. GINSBURG. Thank you, Mr. Chairman.

If it will assist the debate, I will cheerfully declare that mergers and acquisitions, hostile, friendly, either, or both, are terrible things and will destroy the Republic and the American way of life.

Or, alternatively, if it will be of any help, I will be happy to announce a fervent belief that wide-open, competitive, no holds

barred, acquisition markets are the only way to save the Republic and preserve the American way of life.

What I am trying to suggest is that one's view of the desirability of these transactions really has little to do with whether it makes any sense to advance that view through another frightfully complicated set of amendments to the Internal Revenue Code.

At this point I would like to distinguish quickly the greenmail affair from everything else I hope to speak of today.

The tax issue with respect to greenmail, as I see it, is mercifully narrow and comprehensible. Stated in English, it is whether or not a corporation can obtain a business expense deduction for any part of the purchase price it pays when it repurchases its own shares from an overhanging raider.

To tax lawyers, the question relates to the current status of a handful of decisions that initially emerged from the fifth circuit, headed by the *Five Star Manufacturing Co.* case. Personally, I really do not think those cases reach or approve a deduction for greenmail payments; if Congress wants to place that beyond doubt, I think it can do so without undue damage to the tax system.

I believe you asked Mr. Jones, earlier, what language one would adopt. A nice thing about being a school teacher; we are always prepared to make recommendations on such things. I would suggest something along this line: except as otherwise provided in section 83(h), relating to certain transactions with employees and the like, a corporation shall not be allowed a deduction for any part of the purchase price paid in the repurchase of its shares. I would rather think that would do it.

Chairman PICKLE. Where is that in your testimony, what page?

Mr. GINSBURG. Nowhere. I figured that having inflicted on you 31 pages of written testimony, it would perhaps be more interesting to spend the oral part reacting to things that others said at the hearing on April 2, and earlier today.

Chairman PICKLE. We will be glad to read that full statement. Thank you.

Mr. GINSBURG. Mr. Chairman, my overall plea today is not complicated. It is, please do not inflict on us another set of piecemeal legislative changes in subchapter C. For one thing, my students will not survive it. For another, the country is drowning in the sea of discordant, complicated, almost unworkable tax legislation.

Let us either undertake a genuinely thoughtful, careful, broad-based reform of the system, which I, and I assume almost everybody else, would truly favor, or let us leave it alone, at least for a while.

Now, of course, it cannot work exactly that way. For one thing, there is on the table legislation relating to net operating loss corporations. There have been hearings on that already, and I assume that before yearend we will actually have some legislation, else the often postponed 1976 amendments will come into play, and we will all find ourselves desperate.

Also there is the technical corrections bill; by all means, let us have technical corrections to repair what we did last year.

But other than those two things, I would hope the committee would go very slow on more corporate tax legislation, at least for a while.

Mr. Jones, an hour or so ago, said that his committee, after study, had concluded the best way to approach some of the takeover problems that are now on the table is through the Internal Revenue Code. I was reminded of an experience before this committee 10 years ago.

The Ways and Means Committee held a series of hearings with invited panels. I had the good fortune to be on one, along with four other invitees, to spend a day talking about tax reform and tax simplification. I remember it because one of the other invited witnesses, I think in high dudgeon, pointed at the whole committee, and said that it seemed to be an article of faith in Congress that the best way of solving any and every economic, political, social, moral, religious or constitutional problem is through another amendment to the Internal Revenue Code.

Actually, I believe the speaker at the time said another lunatic amendment to the Internal Revenue Code, but I think he was overwrought.

This is a concern today, I think. It is not desirable to continue trying to solve nontax problems through the tax law. It is, after all, a good deal of what has brought the Internal Revenue Code to its current state of near perfection.

Without question, the tax law does affect, often fuels and in rare cases inhibits the fact and the form of corporate transactions. Many of us, perhaps all of us, would wish the tax law were a good deal more neutral in decisions to acquire or combine or divest or redeem stock.

But to achieve that kind of tax neutrality really would require major changes, major conceptual changes, in the system. We are not dealing with narrow issues, to be the fruitful subject of another quick fix in the Internal Revenue Code. In my written testimony I have attempted to suggest why that is so. I think the questions that a number of the members of this committee addressed to prior witnesses confirms that you well appreciate some of the reasons, but let me reflect briefly on just two or three.

First of all, as a matter of sensible tax law—odd words to use in conjunction—there really cannot be a difference between a hostile takeover and a romantically affectionate takeover.

Like many of you, I doubt I can tell the difference, in a large number of cases anyway, and in any event hate does turn to love, and the reverse, and as of what day is one to judge the warmth of the affection between the parties. But that is really not the significant issue. As a matter of tax law, hate and love are irrelevant.

Second, as a matter of sensible tax law, there is really no difference between an acquisition that uses borrowed money, true debt, and an acquisition that uses retained earnings. That is a matter of rather uncomplicated arithmetic.

And, third, as a matter of sensible tax law there is no difference between an acquisition of a public target company by a purchasing company, and a simple redemption of publicly held shares by either of those companies. The impact on the tax base, the corporate tax base, is exactly the same, and that, you see, is really what so much of this is about.

I think Mr. Flippo said it on April 2: do not these leveraged transactions actually result, in some cases, in an increased cash

flow for the benefit of the shareholders. The answer is yes, but it is yes whether the transaction is done paying out borrowed money or retained earnings.

Now, if you want to get into the question, how should we properly tax transactions in which the corporate tax base is being reduced through nondividend distributions, you will be playing in a very big chaotic game, and not one that one played—or fixed—easily.

What I am saying then is that all of these things are part of one general concern in the tax law. And if they are going to be addressed sensibly, they ought to be addressed coordinately as a part of an overall form of the system.

As to the question of the interest deduction, and is there anything special about it, I do not think so, assuming the debt is truly that.

Having this forum, I would like to make a proposal. I would make if I were king, although I am not sure I am truly serious, but let me make it any way. Why do we not just disallow the deduction for all interest expense across the board, without limitation—I would be prepared to negotiate the home mortgage interest deduction—and declare all interest income tax free? That will solve, not only a great many problems that we have today, but think of the impact on the national debt if interest income for holders of Treasury bills were tax free.

We would, I think, substantially reduce the national debt very quickly, since part of the debt is the cost of carrying. Of course, the States would be somewhat unhappy about this. What I am trying to suggest here, in line with the way I opened this testimony, is that solving a great host of problems through the tax system, while it may be appealing, really it is not a way to go, without a great deal of thought about the impact of what you are doing.

Thank you.

[The prepared statement follows:]

STATEMENT OF MARTIN D. GINSBURG, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY

Messrs. Chairmen and members of the Subcommittees, my name is Martin D. Ginsburg. I am a Professor of Law at Georgetown University Law Center where I teach various subjects in the field of federal taxation. Over the past fifteen or so years it has been my privilege to testify before the Ways and Means Committee on a number of occasions, at times at your request, at times on behalf of a bar association group, more often simply out of an interest in the subject, but never on behalf of a client. I appear today as an academic witness but not, I trust, a disinterested one.

The Committee today focuses on corporate combinations and corporate acquisitions. In initiating these hearings, the Committee may contemplate a new round of selective subchapter C legislation. With that fear to the front, I would like to begin my testimony with a petition from the heart: Please, don't.

It is not that corporate tax law has become wonderful as a result of your 1980, 1981, 1982, and 1984 tax changes. It has not become wonderful. It has in important respects been substantively improved, mainly through the 1982 and 1984 Acts. But at a cost in new problems, new loopholes, and proliferating complexity of frightful proportion.

Donald C. Lubick, a former Assistant Secretary of the Treasury and in his youth a Buffalo lawyer, some years ago offered the shortest and best essay I know on extremely complex corporate tax provisions. He said, "There are no collapsible corporations in Buffalo."

There is a point at which precipitous, piecemeal tax legislation becomes largely counterproductive. The merits of particular amendments are overwhelmed by a giant wave of confusion. The corporate tax law, I believe, has passed that point.

The nation is drowning in a sea of discordant, complex, confusing tax legislation. Taxpayers, lawyers, accountants, revenue agents, judges, and poor oppressed academics are awash in a sinking ship. There are no collapsible corporations in Buffalo, and scarcely any elsewhere, because the pornography rule does not work. Intimidated by an abundance of exceptions, limitations, and special rules, relatively few practitioners and a lot fewer revenue agents know a collapsible corporation when then see it. A highly articulated statutory scheme, one of the longest substantive provisions in the Code, and in a large way we coexist with section 341 by disregarding it. That approach is not unique to section 341.

In 1982, according to Assistant Secretary Pearlman's Senate testimony last April, Congress enacted section 338 "to simplify and improve the tax treatment of taxable stock acquisitions." The provision's operative notion, an explicit election substituted for the corporate liquidation mechanics of prior law, eminently sensible and simplifying in concept, attracted a good deal of practitioner approval when the TEFRA legislation was first proposed. But as enacted in the Summer of 1982 and technically amended early in 1983 and again in 1984, section 338 has so far proved a substantial misfortune. Treasury and the Service, despite much hard work by many very bright people, in two-and-a-half years have been unable to promulgate a substantive regulation—at least to the moment of this writing—and taxpayers who made corporate acquisitions in 1982 do not, in March of 1985, know if they should or should not file a section 338 election retroactive to that earlier time.

There are a few reasons why section 338, which could have been a model of relative sanity in the corporate tax law, emerged a turbulence of complexity. But one stands out. It is the so-called consistency requirement and it offers a powerful lesson, if any is needed, about corporate taxation and tax legislative process.

The consistency requirement is in section 338, just about all agree, to serve as a surrogate—most commentators I believe would assert an inadequate and ill conceived surrogate—for a systematic reexamination and substantial overturning of the General Utilities rule, sections 336 and 337 and in smaller part section 311. Congress was unwilling to undertake the encompassing task in 1982, and in at least one respect that reticence is understandable. Complete General Utilities reform implicates at least in one part the deeper issue of double taxation relief and that issue ought to be addressed, with much thought and care, as part of a broad subchapter C reform project.

And that is the real point of this lengthy introduction. I suspect, certainly I hope, that I call out on behalf of multitudes in urging that Congress in the corporate arena channel with some precision its tax legislative efforts.

First, there is one pressing piece of unfinished business. Before the end of 1985 Congress must again come to grips with the loss corporation problem. Either Congress must legislate a further postponement in the effective date of the section 382 changes that first were enacted in 1976, or Congress must enact a new and more sensible version of section 382. I will return to the latter choice in a few minutes.

Second, there is the inevitable necessity of a Technical Corrections Act to repair the 1984 Tax Reform Act. By all means, give us that legislation. Indeed, I hope you will concentrate on "repair" and not exclusively on "technical" since there are 1984 Act misfortunes—for example the Code's now senselessly disparate definitions of corporate affiliation—the correction of which may not be narrowly technical but surely is essential to the well being of taxpayers, the fisc, and perhaps both.

Finally, there is the Utopian ideal of genuine tax reform. The Treasury's proposals of November-December, 1984, which in the main I find very fine, focus only occasionally on corporate-shareholder tax matters but, if enacted more or less intact, ought to impel thorough subchapter C reform. After all, in a world in which capital gains do not attract a preferential rate and partial integration of corporate and shareholder taxation is the norm, all of the subchapter C provisions that deal directly or indirectly with corporate distributions are ripe for revision. Further, even if the pertinent Treasury proposals do not carry, an encompassing reform of subchapter C can be undertaken. In 1982 the American Law Institute's Federal Income Tax Project, after eight years of study, published its subchapter C report. Building on that base, commencing in the latter part of 1982 the staff of the Senate Finance Committee, together with other government personnel and consultants from the private sector and the academic community, has labored long and diligently to produce a serious subchapter C revision bill. The ALI product was not flawless, and none would expect that the Finance staff product will be flawless, but there is every reason to hope it will be on the right track. That it will seek to deal directly and

consistently with the core concerns in the subchapter C taxing regime, and will not be restricted to the tinkering with technicality that has brought subchapter C to its current level of complex inadequacy.

That in essence is today's plea. Legislation to deal with loss corporations and sections 382 and 269, I would hope so. A 1985 Technical Corrections Act, by all means. New and different subchapter C amendments as part of an encompassing, carefully considered corporate tax revision, either incident to broad base general tax reform or, less cosmically, along the lines of the American Law Institute's study, again I hope so. But, please, unless the Republic will truly crumble in its absence, do not so soon inflict on us another set of piecemeal changes in our already Byzantine corporate tax system.

The tax law is sometimes neutral, or approximately so, in corporate acquisitions and combinations. Most of the time the tax law is not neutral; a transaction that appears commercially advantageous without regard to tax considerations will attract, or can be designed to attract, tax consequences that render the transaction that much more (or in very rare cases that much less) desirable. And there are circumstances in which the tail and the dog change places; a transaction that likely would not be undertaken absent tax considerations is viable because there are tax considerations and they impact favorably at the corporate level, the shareholder level, or both.

In his March 8 announcement of these hearings, Chairman Rostenkowski asked that witnesses testify about the degree to which the Internal Revenue Code influences merger and acquisition decisions by providing tax benefits upon a change in ownership of a corporation, benefits that would not be available absent the change in ownership. Chairman Rostenkowski also noted that the hearings will not focus exclusively on provisions of subchapter C, but will take into account other Code provisions which, while applicable to arrangements other than corporate acquisitions, may play a special role in those transactions. In what follows I will try to follow the directives implicit in the Chairman's announcement.

I. LOSS CORPORATIONS

Section 382, in the version currently operative, applies different tests to the acquisition of a loss corporation by purchase and to the acquisition of the assets and attributes of a loss corporation in an acquisitive asset reorganization. The purchase provision looks to the combination of change of business and change of majority ownership of the loss corporation, and applies a rule of all or nothing. The reorganization provision embraces a proration concept and looks to a moderate continuity of shareholder interest in the combined enterprise on the part of the historic loss corporation investors. Overlaying the detailed rules of section 382 is the general tax avoidance proscription of section 269, a provision which with some justification has been called the blind policeman of the corporate tax law.[1] Finally, if the loss corporation and its corporate purchaser file on a consolidated basis, the consolidated return regulations impose SRLY and built-in loss restrictions on the utility of the loss carryover. The present system, in sum, is inconsistent, complex, and often uncertain in application, and owes remarkably little to the sensible notion that acquisition of the loss corporation ought not affect significantly, positively or negatively, the value of the tax benefit the loss likely will produce. The strongest thing that may be said in support of present law is that in important respects it appears to be superior to the 1976 enacted revision of section 382 that is slated to come into effect in 1986.

The neutrality notion, the idea that a net operating loss ought to have approximately the same value after a corporate acquisition as before, underlies the approach to loss corporations taken by the American Law Institute's Federal Income Tax Project, in its Subchapter C Report published in 1982. That study, in turn, has influenced significantly academic output during the past three years, the testimony proffered at last year's Ways and Means Committee hearing on loss corporations, and a recently adopted legislative resolution of the Section of Taxation of the American Bar Association. While all of the proposals enjoy a degree of conceptual consistency, they differ significantly in means of implementation. Since the Subcommittee on Select Revenue Measures intends to consider specific proposals at a later date, I will limit my comments on loss corporation transactions to a few general points.

First, limiting net operating loss utility, after a corporate acquisition, by reference to a reasonable calculation of pre-acquisition utility is sound. In essence, it focuses

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[1] Donald Shapiro of the New York Bar was the first, as far as I know, to sum up section 269 in this way.

on the loss corporation's pre-acquisition capital available for investment, and appropriately disregards the continuation vel non of the business that produced the loss.

Second, among the issues of implementation Congress must resolve two stand out. What of loss corporation indebtedness if, for example, the entity is solvent and creditors exchange debt for stock which then is purchased in the corporate acquisition? More important still, what notional rate of return will be ascribed to the loss corporation's capital, however that capital may be defined?

Third, what if any role will be played in the new world by section 269? If the answer is none, certainty of tax consequence will be measurably enhanced. But the potential for mischief, for example when losses are not yet realized and are built into a high asset basis, also will be measurably enhanced.

Finally, however well designed the next version of section 382 may be, it will not likely prove efficient in addressing an important class of loss corporation problems. Alternative to acquisition of a loss corporation by a profitable one is a joint venture between the companies, a partnership to acquire and exploit a business producing substantial annual income. The desired arrangement will deflect a disproportionate share of that income to the loss corporation for five or more years. Cash representing that deflected income will not, however, be currently distributed to the loss corporation; instead, that partner's capital account will be increased, the increase to be paid out in cash twenty-five or thirty-five or more years down the line. In the meanwhile, after early years the loss corporation's distributive share will shift from a high percentage of profits to either a low percentage of profits or a fixed return on capital account. In the result, a great deal of income will go untaxed and, measured in terms of present value, the profitable corporate partner and not the loss corporation will enjoy a disproportionate share of the benefit.

Arrangements of this sort are not new, but in number and size they appear to be on the increase. The focus of concern is the partnership tax provisions (subchapter K), explicitly section 704(b) and most explicitly the proposed regulations under it. It is not, I think, a problem that requires yet another legislative solution; Treasury's authority to respond by regulation seems ample. How Treasury will respond is not at all clear, and perhaps the Committee in this area has an oversight role to play.

II. DEBT FINANCED ACQUISITIONS

With the insignificant (in realistic terms) exception of section 279, the Code does not disallow an interest deduction when P corporation debt-finances its purchase of the stock or assets of T (target) corporation. Should that result be changed; should section 279 be amended so that it will become a factor of significance in the corporate acquisition tax calculus?

Other than in response to a general indexing of interest expense/income (or indexing of indebtedness), my own view is that we ought not disallow a deduction for interest attributable to corporate acquisition indebtedness. I believe there are important debt-financed acquisition problems that ought to attract Congressional attention incident to overall tax (or even corporate tax) reform, but the deductibility of interest on true corporate debt is not among them.

If profitable P corporation, historically not a large distributor of dividends, has accumulated sufficient surplus, it may purchase T using its retained earnings. If P annually has distributed large dividends, or simply has not operated at large profit, it must substitute debt financing for internal financing in acquiring T. I can think of no good reason why the tax law, by denying an interest deduction, ought to penalize the less solvent P and thereby grant a substantial relative advantage to acquiring corporations able to finance acquisitions internally. If the goal is, as it ought to be, enhanced neutrality of the tax system, this will not achieve it.

There are, I believe, other and sizable tax problems in corporate acquisitions that are purchases. One is equally present whether the acquisition is internally financed or debt financed. Another arises in a debt-financed acquisition of a specific sort. A third problem is considered separately, below, in part III B.

A. Reduced corporate tax base

If the shareholders of T corporation are individuals and P corporation purchases T for $100 million, the former T shareholders receiving capital gain treatment, a tax problem is presented that transcends the method of financing. Whether P pays the purchase price in cash out of its retained earnings or out of borrowed funds, or issues debt which it later pays with internal or borrowed money, the corporate tax base is reduced by $100 million. If that sum would generate at the corporate level earnings of $10 million yielding $4,600,000 in corporate tax, as a result of the transaction there will be $4,600,000 less corporate tax collected in the following year. The historic shareholders of T at some point recognize gain on the sale, but for virtually

all of them it is capital gain. As Professor Andrews convincingly demonstrated in the course of his work on the American Law Institute's Federal Income Tax Project, the present value of the corporate tax saving overwhelms any likely shareholder tax detriment. Indeed, it can be argued with some force that it is this general corporate level advantage, and not the narrower manifestation of it that lies in the deductibility of interest on acquisition indebtedness, that significantly assists purchasing corporations in paying above-market premiums for target companies and thereby encourages corporate combinations. This perception, in turn, argues that the appropriate response to the tax law's current non-neutrality resides, not in distinguishing internally financed and debt-financed acquisitions, but rather in focusing on the tax treatment of the non-corporate sellers.

Put simply, the conceptually correct solution is to extract a full measure of tax (as distinguished from capital gain tax) whenever money or other property leaves corporate solution. Mechanically, that result can be accomplished through dividend taxation at the shareholder level or, if the shareholders are granted capital gain treatment, imposing a compensating excise at the corporate level. Without belaboring details, the excise will, as conceptually it must, vary directly with the size of the section 1202 deduction (currently 60% of long-term capital gain).

A regime of this sort would not be without mechanical problems, but the essential problem, not at all complicated, is that it is near to inconceivable that Congress would adopt a taxing scheme of this sort. It is not, after all, merely corporate acquisitions that stand hostage; every stock redemption and corporate liquidation, when the shareholder is not itself a corporation, stands hostage.

At the outset of this testimony I urged that the Committee refrain from piecemeal corporate tax legislation and channel its efforts, ideally, in coordination with general tax reform. The case at hand lends support. The Treasury's tax reform proposals of November-December, 1984, among many other things would eliminate the preferential tax treatment of capital gains and provide corporate-shareholder partial integration through a 50% dividends paid deduction. In that world, the the section 1202 deduction having disappeared, the Lion's share (certain basis recovery concerns remain) of the corporate acquisition problem here in focus also disappears. Corporate acquisition concerns that appear virtually intransigent in the current tax world will neither appear nor be anything of the sort in the tax world contemplated by the Treasury's 1984 reform proposals.

Let me close this portion of the testimony with a glance at leveraged buy outs. Large P corporation has an operating division or subsidiary managed by Mr. A and Ms. B. Those individuals wish to acquire the business they are managing and P corporation willingly or unwillingly will go along. The price is $40 million. A new corporation, Newco, is organized. For perhaps a total of $1 million, Mr. A and Ms. B acquire, let us say, 50 common shares of Newco. The V Group, venture capitalists, for $4 million acquire convertible preferred stock of Newco which, when the conversion right is exercised, will turn into 50 Newco common shares. An institutional lender or group of lenders furnishes the balance of $35 million to Newco and will receive from Newco during the first year interest of $5 million.

In the hands of P, let us assume, the target business was internally financed. In the hands of Newco it is debt financed, and a large part of the income of the business will service deductible interest expense. But the institutional lenders are corporations, interest received is income to them, and if on this income the institutional lenders paid full measure of corporate tax we should view with indifference the leveraged buy out's substitution of external debt financing for P's internal financing. In fact, of course, financial institutions enjoy special tax treatment, for example a formulary bad debt reserve computation, that greatly reduces their effective tax rate. Here again we deal with a phenomenon outside subchapter C and here again the appropriate solution, as the Treasury proposals recognize, lies in general tax reform.

B. Installment sales

If, to repair to an earlier example, P purchases the stock of T (or the assets of T which promptly liquidates) for debt obligations of P that are not readily tradable, a separate tax problem arises. Indeed, the problem arises if P acquires T by merger issuing in exchange mainly P shares and, to some T shareholders, mostly or entirely P debt obligations that are not readily tradable. Under section 453 (subsection (f)(6) in the merger case), the former T shareholder receiving P notes will report the transaction on the installment method, deferring recognition of gain until payment is received or the P notes are earlier disposed of.

A simple example will focus the tax problem. Assume Mr. A holds at a zero basis T shares for which P will pay $10 million. If P purchases for cash, Mr. A must pay

$2 million of capital gain tax and will retain $8 million to invest at, let us assume, a 12% market rate of interest. If instead P issues in exchange a $10 million promissory note, interest at 12% payable annually, while the note is outstanding Mr. A will receive interest on his $8 million and interest on the Government's $2 million. That arrangement, the equivalent of an interest free $2 million loan to Mr. A from the Government, is not a reward for risk since under section 453 installment reporting is available although the P note may be secured by a standby letter of credit issued by the largest and most solvent bank in the Nation.

Well advised taxpayers fully understand the inordinate advantage that currently inheres in the failure of the tax system, when a fixed payment sale is reported on the installment method, to charge interest for or otherwise tax the privilege of deferral. In many corporate acquisitions, particularly for the benefit of the largest T shareholders, installment reporting is built into the P-T transaction. In many cases, when deferred payment is not part of the acquisition transaction, investment banking firms stand ready to purchase for fully secured installment paper T shares from the largest T shareholders; the investment banking firms in turn sell these T shares to P for cash and, blessed with the full purchase price basis that derives from the notes they have issued, recognized no gain on the sale. I know of no way the current tax treatment of long-term installment sales can be justified. Enormous amounts of revenue, I would hazard billions of dollars annually, escape tax. The problem of course is not limited to corporate acquisitions, and once again the matter is appropriately addressed as part of general tax reform.

But here it will have to be Congress that takes the lead. The 1984 Treasury proposals advert to the installment reporting problem, describing it with precision, but for stated reasons I find unconvincing suggest nothing be done.

III. THE GENERAL UTILITIES RULE: GAIN RECOGNITION AND BASIS RECOVERY

When P corporation acquires the assets of a T (target) corporation that liquidates, or buys the stock of T and files a section 338 election, the basis of T's assets is stepped-up to reflect purchase price. That would be well and good were T corporation fully taxed on the gain.

But it has been the normative rule in our system, the so-called General Utilities doctrine, that nonrecognition is the rule, recognition of gain the exception, when a corporation sells or distributes appreciated property. Commencing in 1954, and more recently at an accelerating pace, Congress has carved out many exceptions to the General Utilities doctrine. Examples include complete recapture of depreciation in the case of personal property, recapture of accelerated depreciation for realty, and the triggering of LIFO inventory reserve. With respect to appreciated property distributions by a corporation that is not completely liquidating, in the 1984 Act Congress wholly reversed field, amending section 311(d) to make gain recognition by the distributing corporation the normative rule, General Utilities nonrecognition the exception.

Although Congress has chipped away at the General Utilities doctrine for more than 30 years, in the complete liquidation context it remains potent. Under current law, in an otherwise taxable "cost basis" acquisition T corporation is not taxed, ordinarily, on a significant part of the appreciation in the value of its assets. To the extent P corporation or P's corporate group (which will include "new" T corporation after a stock purchase and section 338 election) can make efficient tax use of the stepped-up asset basis, current tax law unduly rewards the corporate acquisition. In Chairman Rostenkowski's words, current law provides a tax benefit—the coupling of nonrecognition and asset basis step-up—upon a change in ownership of a corporation that would not be equivalently available absent the ownership change.

In examining the General Utilities problem it is conventional to concentrate on T corporation and its shareholders. I will follow that convention but thereafter shift focus to examine the tax benefits achieved by the P corporate group in a cost basis acquisition.

A. T Corporation and its shareholders

The appreciated assets of T corporation that attract nonrecognition of gain under sections 336 and 337, current law's main embodiment of the General Utilities doctrine, loosely may be grouped this way.

Appreciation in excess of original cost, often attributable largely to inflation, exemplified by noninventory investments in undeveloped land, portfolio securities, buildings held for investment or productive use, and intangible assets of the "goodwill" sort. Generically, what I will call capital appreciation.

Appreciation, above adjusted basis but not in excess of original cost, attributable to depreciation or amortization or cost depletion or other previously enjoyed

tax deduction that did not mirror an equivalent decline in economic value. I concentrate here on appreciation that is not subject to the recapture rules of current tax law, for example the value of real estate, above adjusted basis but below original cost, when depreciation was taken on the straight line. Generically, I will refer to this sort of appreciation as tax benefit appreciation.

The appreciation in ordinary income assets, dominantly FIFO inventory, that is not subject to current law's recapture or other recognition rules. I will term this category operating profit appreciation.

At the simplest, the General Utilities doctrine provides a measure of relief from double taxation—taxation at the corporate level and taxation at the shareholder level—when the enterprise is terminated, asset basis is stepped-up in the buyer's hands, and the shareholder's cash in their investment. I conceive no sound reason why double taxation relief, in the form of a General Utilities exclusion from corporate income or in any other form, should be available for tax benefit appreciation or operating profit appreciation. In the case of tax benefit appreciation, by definition the "profit" is merely the reversal of a deduction T corporation earlier enjoyed, a deduction that did not reflect a concomitant decrease in economic value. For tax benefit appreciation I do not here suggest a change in the quality of the income, which under current law in many cases would be capital gain, but I do urge that the income ought not be exempted, as in most cases it now is, from all corporate tax. In the case of operating profit appreciation, although some portion of the computed gain may be attributable to inflation the current arrangement—elimination of all corporate level income while allowing shareholder level capital gain—places an exorbitant premium on selling out the company. Relieving the tax burden on inflationary gains may be sensible indeed, but the concern is hardly restricted to the corporate acquisition arena and the solution, if there is to be one, resides in general tax reform of a major sort.

Capital appreciation, value in excess of the original cost of capital assets and trade or business property, seems to me distinguishable. Here the case for relief from double taxation has strength. But the issues meriting careful congressional attention are not trivial. How long must a capital appreciation asset have been held by T corporation before it becomes a fit subject for double taxation relief? Will smaller corporations and their investors receive greater relief, large public companies less relief or none? Whoever is to receive it, what form ought that relief take: a corporate level exclusion of the General Utilities sort; a shareholder level credit (either limited or cashable) for corporate tax attributable to liquidation generated capital gains; deferral of shareholder tax, when corporate assets are distributed in kind, through an appropriate reduction in the shareholder's basis in those assets? What if any changes shall be made in subchapter S, relative to the C corporation that shifts to S status and shortly sells its assets?

Tax benefit appreciation and operating profit appreciation may merit the Draconian solution, as I am persuaded they do, of uncompensated elimination of the General Utilities benefit, but for capital appreciation in long-held assets—the ALI's Subchapter C Study suggested five years—the quick and simple fix of an uncompensated, across-the-board repeal of sections 336 and 337 would be excessive. The matter might be viewed quite differently, appropriately so, if the 1984 Treasury reform proposals for elimination of the capital gain preference, substitution of indexing, and general double taxation relief through a dividends paid deduction, were enacted. But in the absence of a complete restructuring of this sort, for long-term capital appreciation sections 336 and 337 should be revamped only incident to an encompassing reform of subchapter C, one that replaces the present form of double taxation relief with a construct better designed to achieve that sensible end.

B. The Purchasing Corporation

When P corporation purchases for cash the assets of T, or the stock of T making a section 338 election, a purchase price basis for T's assets is appropriate. That ought not end the inquiry.

In cost basis corporate acquisitions a special, often sizable, on occasion impelling tax advantage lies in asset transmutation. As a best case, what was a substantially appreciated, low fixed basis asset of T corporation prior to the acquisition is metamorphosed into a high basis wasting asset by virtue of the corporate acquisition. In the result, the P corporate group through depreciation or amortization deductions over a fairly short period of years avoids tax on a significant part of the income generated by the acquired business. Indeed, if the income generated by the former T business should prove less than the aggregate deductions—depreciation or amortization, interest expense on acquisition indebtedness, and so forth—the acquisition

yields, in a proper tax structure the P group will offset the excess deductions against income generated in other segments of P's business.

Transmutation tax planning often centers on T's intangible assets. In early times it was conventional to view the value of T's business, in excess of the tangible asset value of that business, as undifferentiated "goodwill," a fixed basis asset the cost of which could not be amortized for tax purposes by the purchaser. More recently, under what is sometimes termed the Seaboard Finance line of court cases, purchasers have enjoyed substantial success in avoiding unitary asset treatment of the bundle of intangible property which, in the seller's hands, was simply considered goodwill. As an illustration, assume T corporation sells its small loan business to P for a purchase price $1 million in excess of tangible net asset value. T will view the $1 million as a realization upon the intangible capital appreciation of the business and, under section 337, avoid recognition of gain. P corporation, however, after careful professional appraisal and analysis, will determine it has paid $900,000 for the newly identified premium value of certain groups of small loan contracts and only $100,000 for the residual goodwill or going concern value of the business. Concluding that the premium value of these small loan contracts is, in P's hands, a wasting asset with a useful life not in excess of 5 years, P will proceed to deduct the allocated $900,000 over those 5 years, $180,000 each year. That, in essence, is the theory the purchasing taxpayer advanced, and the success it achieved, in Seaboard Finance. Faced with all sorts of business acquisitions, the tax bar in recent years has proved wonderfully clever at sculpting amortizable artworks out of the plain bare rock of seller's goodwill. It is interesting to speculate on the number of leveraged buy outs in which asset transmutation, the discovery and exploitation of amortizable premium values, has played a vital part.

I think we can devise a more sensible regime for taxing the intangible assets of a going business. The current system is unbalanced. T corporation obtains General utilities nonrecognition in all liquidation cases, a sale of goodwill governed by section 337 and a liquidating distribution of goodwill to the shareholders (who will continue the business) under section 336. The acquirer, P corporation in the purchase and the T shareholders in a liquidation in kind, in some cases receives no tax benefit—no separate amortizable intangible emerges—and in others obtains extraordinary tax benefits through very large amortization deductions.

Balance can be restored in a straightforward way:

> Provide as a normative rule that the General Utilities doctrine, and whatever form of double taxation relief may replace the doctrine hereafter, will not apply to the appreciation in T's "goodwill." The person acquiring T's intangible assets in a cost basis acquisition (P corporation or, if T is liquidated in kind, T's former shareholders) will be free, as now, to root among the intangibles in search of amortizable assets.
>
> As an elective alternative, T and P corporations may jointly designate a carryover basis in T's intangible assets. P will thus forego any claim to an amortization deduction of allocated purchase price, and T and its shareholders will be awarded double taxation relief.
>
> An equivalent election ought to be available when T corporation, liquidating in kind, distributes to its shareholders the tangible and intangible assets of its business. If the shareholders agree to award no basis to goodwill-derived assets, certainly double taxation should be avoided. Indeed, it can be argued with some force that, if the T shareholders agree to a zero basis in the distributed intangible assets, neither T nor the T shareholders should recognize gain on that portion of the liquidating distribution. If and when the former shareholders sell the business, the purchase price allocable to goodwill then will give rise to recognized gain. Sensibly, the gain should be capital gain if the buyer consents to carryover (zero) basis, ordinary income if it does not.

A separate issue, regarding the taxation of P corporation, relates to contingent purchase price acquisitions. If P purchases depreciable property from T for consideration that is in part contingent—an amount to be paid four years hence based upon the productivity or profitability of the asset in the interim—P's depreciable basis in the asset will not, during that four year interim, include any amount derived from its promise of contingent payment. That is sound. In year-4, when P calculates and pays an additional sum (together, let us assume, with adequate interest), that additional sum then will be added to P's adjusted basis in the asset. That again is sound.

If the asset has a five-year ACRS life, under proposed regulations P will recover against income the additional basis amount, not over the ensuing five years, but over the two year balance of the original ACRS term. Proposed Tres. Reg. (1.168-2(d)(3)(i), (ii) Example (2). Under the installment reporting method, in the mean-

while, the seller has deferred tax liability on the contingent payment until the cash is received.

Here again the current system is unbalanced. But in the contingent payment case the appropriate solution is not to charge interest to or otherwise tax the seller on the deferral privilege; delaying four years the buyer's depreciation deduction stands surrogate, or would if the buyer's depreciation deductions were spread over the term to which they would be allocated if, in year-4, the buyer newly purchased an interest in depreciable property from the seller. By compressing five years of deductions into two years, the Treasury's proposed regulations create, in the aggregate, an overly hospitable tax climate for contingent consideration purchases of depreciable property. This is not a problem that mandates a legislative solution. Treasury, if it wishes, can respond through a revision of its proposed regulations. The contingent payment transaction does, however, present an aspect of the installment sale problem, outlined above in part II B, and if as there suggested it is Congress that must take the tax reform lead, Congress may well find itself in the director's role with regard to contingent payment cost recovery.

IV. CONCLUSION

I conclude by repairing to the place at which I started. Certainly current tax law substantially influences corporate combinations and corporate acquisitions. Certainly that is not an ideal state of affairs. The tax law ought to be neutral, as nearly as feasible, in business and investment decisions of this sort.

But the ways in which the tax law currently influences merger and acquisition behavior are, dominantly, quite different from the arrangements Congress reviewed, deplored, and legislated against in 1982 and 1984. Then, the focus was mainly upon provisions of relatively narrow compass and acquisition plans tailored to exploit statutory or regulatory misfortunes of that narrow but lucrative kind. The partial liquidation of T corporation, newly purchased and newly included in P's consolidated return, was perhaps the prime but certainly not the exclusive example under pre-1982 law.

The merger and acquisition concerns under present tax law are largely of a different quality. They implicate basic, pervasive taxing concepts: Shareholder capital gain treatment in transactions that reduce the aggregate corporate tax base; the untaxed privilege of deferral in fixed payment installment sales; the continuing application of the General Utilities rule as the method of double taxation relief in corporate liquidations. This is not the stuff for which quick fixes are made. This is the stuff of serious, encompassing, careful tax reform.

In 1982 certainly, and in 1984 I fear as well, we found ample reason to conclude that the process is the reality. A specific change in the tax law, crafted in isolation and in haste and closely targeted to a selected abuse, all too likely achieves its aim at the cost of creating a new avoidance opportunity speedily exploited by our marvelously ingenious tax bar. The 1982 correction of prior law's partial liquidation abuse confirmed a broad avenue of alternate tax abuse: Extraordinary intercorporate distributions of low basis assets by recently purchased target corporations. The 1984 Tax Reform Act cut down that opportunity. But the same legislation, in propounding disparate definitions of intercorporate affiliation relationships, created new tax avoidance opportunities of staggering potential. They arise out of definitional differences in sections 332, 337, 338, and 1504. I have no doubt the next tax bill will fix things before too much fiscal blood has been let; but so long as there is a continued concentration on piecemeal, reactive corporate tax changes, we will forever engage in a Ping-Pong game in which the ball moves faster and faster, the Government is a strong player, but its opponent, the aggressive tax bar, is a world class performer.

A 1985 round of selective corporate tax legislation would be hazardous to the health of the system. The changes that proved attractive will be comprehended and followed by the well advised. The changes that do not prove attractive will be comprehended by few, including revenue agents, avoided by the well advised, disregarded by the innocent, and perhaps by some of the guilty as well.

It is not a good time to tinker further with the obsessive technicality of the corporate tax system. It is time either to undertake broad and thoughtful reform of the corporate tax system, or for a while to leave the system alone.

Chairman PICKLE. Thank you.

Mr. McKee.

STATEMENT OF WILLIAM S. McKEE, KING & SPALDING, WASHINGTON, DC

Mr. McKEE. Thank you, Mr. Chairman.

My name is William S. McKee. I am a partner in the law firm of King and Spalding.

Until 1983 I was a professor of law at the University of Virginia School of Law, where I taught courses in Federal income taxation. From 1981 to 1983 I was on leave from the university, and I served as the Tax Legislative Counsel for the Department of Treasury. I appear today at the invitation of the committee, not on behalf of any client, and I am privileged and honored to be here.

I have been asked to comment on the role of partnerships in the merger and acquisition area. First, I would like to join with Professor Ginsburg, and ask that you, to the extent that you can, stop undertaking piecemeal tax legislation, and instead, devote your efforts toward fundamental tax reform.

When I came to the Treasury in 1981, out of academics, my goal was really fairly simple. I was hoping that in a couple of years of hard work the Treasury Department could make the tax law so simple that I would have to go back to Charlottesville and teach contracts. Instead, I am afraid that during the 2 years I was with the administration, the Internal Revenue Code went to two volumes, and I went into law practice instead.

So I applaud your efforts toward fundamental tax reform, but I do hope in doing so you will try to repeal provisions of the Internal Revenue Code, try to make the Code a simpler document, and try to resist the temptation in undergoing tax reform to add complexity to the already enormous complexities that we have.

Let me summarize for you quickly the role that the partnership plays in the merger and acquisitions area. First of all, partnerships among corporations can use disproportionate tax allocations to allocate tax benefits to partners who can use them and away from partners who cannot use those tax benefits. This type of structure is generally less economically disruptive than going through a merger or an aquisition, which is an alternative way of utilizing such tax benefits.

The tax rules governing disproportionate allocations reflect the same general tax policies applicable to other tax sensitive transactions, that is, that the tax tail is not allowed to wag the economic or business dog.

In other words, tax planning to maximize the use of tax incentives is generally permissible, as long as the transaction itself has substantial economic consequences, and is undertaken for legitimate business purposes.

In the partnership area these particular rules which govern disproportionate allocations work fairly well. The Treasury is now in the process of finalizing regulations in this area, and, in my judgment, there is no need for congressional action in this area at this time.

Partnership transactions are one of the three principal ways in which tax lawyers structure transactions to facilitate the use of tax benefits. The most common way is through leasing transactions. Even after the repeal of safe harbor leasing a couple of years ago,

traditional leveraged leasing is still by far the most popular means of transferring tax benefits from people who cannot use them to people who can use them.

A second way is through utilizing partnerships involving disproportionate tax allocations. These structures have been common in the oil and gas and real estate industries for years, and they are becoming more popular in the corporate area.

The final way is through mergers and acquisitions, combining profit companies with loss companies. And it is to be kept in mind that oftentimes this loss company is a company that is going to generate losses in the future, because, for example, it is particularly capital-intensive and is therefore going to generate substantial tax benefits through ARCS and tax credits.

The degree of economic disruption and overall difficulty of these transactions is generally inverse to the order I just gave you. Mergers and acquisitions are the hardest to do. They are generally the most disruptive. Partnerships are substantially less economically disruptive, although bringing a partner into a business is something that we all know is to be undertaken with some care. The tax rules governing disproportion allocations are more difficult to deal with than those in the leasing area, and probably less difficult to deal with than in the merger and acquisitions area.

Finally, leasing, as I said before, is probably the simplest way to go. The tax policy underlying the ability to use the benefits in all three areas, however, is about the same.

In the partnership area, disproportionate tax allocations are valid only if they have substantial economic effect. I will get into that a little more in a minute.

In the corporate area there is a panoply of rules discussed in Professor Ginsburg's testimony. I suspect they are summed up most easily by picking on section 269 of the code, which broadly denies any tax benefit from a merger or an acquisition, if the principal purpose of the transaction is tax avoidance.

Leasing also has its own set of rules, generally judicially crafted, such as "substance over form" and "profit motive."

Turning to the partnership rules, the substantial economic effect has two parts. The first part requires that the disproprtionate allocation have an economic effect, that is, the partner to whom the tax benefit is allocated must, indeed, bear the corresponding economic detriment if, in fact, the tax detriment proves to be a real economic detriment.

In other words, if I allocate tax losses to a particular partner, and it turns out that those tax losses are actually economic losses, the partner to whom the tax losses were allocated must also bear the economic losses. This is a very mechanical rule.

The second requirement set forth in both the statute and the proposed Treasury regulations is that the economic effect of the allocation must be substantial. This is a more subtle test. It involves the weighing of the shift in tax consequences of the allocation versus the shift in economic consequences. And only if the shift in economic consequences outweighs the shift in tax consequences will the economic effect be deemed to be substantial.

This is, again, a less precise rule that smacks very much of this section 269 role in the corporate area, which deals with principal

tax avoidance purposes and recalls to mind some of the judicially crafted rules in the leasing area, reflecting the notion that the tax tail is not allowed to wag the economic dog.

Let me illustrate with a simple example that is taken from Professor Ginsburg's testimony. He posits that we have a joint venture between a profit company and a loss company, and under the partnership agreement, we allocate most of the income from the venture to the loss company for a 5-year period and then reduce the amount of income that gets allocated to the loss company to a very small percentage. Tax lawyers correctly read all the rules and they credit the amount of income allocated to the loss company to the loss company's capital account so it meets the economic effects standard.

What is going on here, of course, is the income from the joint venture is being allocated to a company that has a substantial net operating loss so that no Federal income taxes are paid on that income.

The key to the transaction is that no money is distrubuted to the loss company for 25 or 30 years. So, in present value terms, although the income is allocated to the capital account of the loss company in the first 5 years, the actual cash does not show up for 25 or 30 years, and what you have effectively done is utilized that operating loss of the loss company as a way to shelter the income of the venture at a very small economic price to the profit company.

In this particular transaction, the allocations would have economic effect, but the economic effect would not be substantial. Since there would have had a very large shift in the tax consequences between the partners but not a very significant economic shift. Therefore, I believe under the proposed regulations, and certainly under the final regulations that Treasury is working on, the allocations would fail.

More recent transactions have been structured to try to eliminate the substantiality problem and they illustrate the line drawing problem you always have in this area. I understand that in some of the newer deals the capital account of a loss company is credited with say 7-percent interest, and the interest is paid every year so that the loss company capital account has real economic value and the loss company's is, in fact, a real participant in the transaction. Indeed, sometimes the loss company is given a significant continuing profits interest in the partnership. This is obviously a much more difficult set of facts.

We have a policy in our Tax Code of allowing loss companies to rehabilitate themselves, to invest their capital in more profitable ventures. If the continuing role of the loss company in the joint venture is significant such that more is involved than mere tax avoidance, the transaction should probably be respected. My point is that the Treasury Department has substantial flexibility under the present statute to decide exactly where this line ought to be drawn. They are fully aware of these particular transactions. They have received a lot of publicity. I think it is the appropriate role of the Treasury Department and the regulations process to try to decide exactly where the line should be drawn between dispropor-

tionate tax allocations that have substantial economic effect and should be respected and those that should not.

Thank you very much, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF WILLIAM S. MCKEE, KING & SPALDING, WASHINGTON, DC

Messrs. Chairmen and members of the Subcommittee, my name is William S. McKee. I am a partner in the law firm of King & Spalding. Until 1983, I was a Professor of Law at the University of Virginia School of Law, where I taught courses in federal income taxation. While on leave from the University from 1981-1983, I served as the Tax Legislative Counsel for the United States Treasury Department. I appear today at the invitation of the Committee and not on behalf of any client. I am privileged and honored to be here.

I have been asked to comment on the role of partnerships in the merger and acquisition area. Before I do, however, I would like to add my plea to that of Professor Ginsburg: please stop. Piecemeal tax legislation now does more harm than good. In my particular area of expertise—partnership taxation—the 1984 tax legislation achieved marginal improvement in policing abusive transactions at a great cost in terms of complexity and uncertainty. And as in Professor Ginsburg's corporate area, the feverish effort to close loopholes led both to mistakes and new loopholes. Indeed, in a failed attempt to close a loophole which no one is known to have ever exploited—the "California basis strip"—the 1984 Act illustrated (and arguably sanctioned) a new tax avoidance technique.

Please allow the Treasury Department the time to supplement the existing statute through the regulations process. Give the tax bar a chance to catch up. If you are successful in your efforts to reform the tax system—and I hope you are—I beg you to keep simplicity at the forefront of your concerns. Indeed, great progress can be made by simply repealing many of the tax expenditure provisions in the Code, without replacing them with new and even more complex statutory schemes.

Turning to the subject of today's hearings, the role of partnerships in the merger and acquisition area may be summarized as follows: Tax benefits attributable to a new venture can be directed to a taxpayer that can use those benefits if the venture is formed as a partnership among corporations. The formation of a partnership is generally less economically disruptive than a corporate combination achieving the same tax result. The rules which police disproportionate partnership tax allocations reflect the same tax policies applicable to other tax-sensitive transactions—tax planning to maximize the value of available tax incentives is acceptable as long as it is part of a legitimate business transaction with substantial economic consequences as well as tax consequences. The Treasury Department is presently finalizing regulations which will implement this basic policy. There is no need at this time for Congressional action in the partnership allocation area.

The apparent increase in the number of tax motivated mergers and acquisitions should come as no surprise to Congress. When the Treasury Department proposed the ill-fated safe harbor leasing provisions in 1981, one of its primary reasons for doing so was to relieve the pressure to combine corporate tax bases it knew would build up as a result of the enactment of ACRS. It was clear in 1981 that billions and billions of dollars of unused deductions and credits would accumulate in the corporate sector by the mid-1980's. That time has come, and the safe harbor leasing relief valve has been closed.

As the Treasury pointed out throughout the 1981-1982 safe harbor leasing debate, there are three principal techniques for facilitating the use of tax incentives. The most common was, and still is, leasing. Large leasing transactions are generally tax driven, marrying equipment users who have no tax base with investors who can use the tax benefits. The second is by conducting a tax-favored venture in partnership form and allocating the tax benefits to those partners who can use the benefits. Disproportionate allocations to limited partners in the oil and gas and real estate industries have been commonplace for years and are becoming more widespread in the corporate sector. Finally, corporations with unused tax benefits (or which expect to generate such benefits in the future) can be combined with tax-paying corporations through mergers or acquisitions in order that the tax benefits may be used.

Of the three common methods of facilitating the use of tax benefits, the merger/acquisition method is probably the most economically disruptive. But as Professor Ginsburg has pointed out, this method is also subject to a highly restrictive set of rules, which regulate tax considerations to a significant but generally not dominant role. Tax planning through partnerships also has its costs—taking on a partner has

business consequences which are not to be taken lightly, and as discussed below, significant economic consequences flow from disproportionate partnership tax allocations. The least economically disruptive way to facilitate the use of tax incentives is through leasing, which is why the Treasury Department in 1981 chose a modified form of leasing as the easiest way to transfer tax benefits from those who cannot use them to those who can.

The partnership rules applicable to disproportionate allocations of tax incentives are consistent with what appears to be the current policy towards tax benefit transfers: taxpayers are permitted to shift tax incentives among themselves as long as the business aspects of the transaction outweigh—or at least equal—tax considerations. Thus, section 269 of the Code disallows tax benefits arising from a corporate acquisition if its principal purpose is tax avoidance, and the repeal of safe harbor leasing reinstated the judicial substance-over-form and profit-motive rules applicable to leasing transactions. In the partnership area, section 704(b) of the Code provides that tax benefit transfers are permissible as long as the allocation which effectuates the transfer has "substantial economic effect."

The Treasury Department has proposed regulations under section 704(b) which require that allocations have economic effect and that the economic effect be substantial. In order to have economic effect, the partner being allocated the tax loss must bear the economic risk associated with that loss. In other words, if the loss turns out to be real, the partner to whom the tax loss was allocated must bear the corresponding economic loss. Even if the allocation has economic effect, it will not be respected unless the economic effect is "substantial." Substantiality is not a precise test; it requires a weighing of the shift in tax consequences produced by the allocation against the corresponding shift in economic consequences. If the tax shift is large and the economic shift small, the economic effect is not substantial and the allocation is invalid. The substantial economic effect test for partnership allocations is thus the analog of the tax avoidance standard applicable to corporate acquisitions and the judicial rules applicable to leasing transactions. Although each set of rules has its own nuances, they all reflect the same policy that tax considerations should not be permitted to be the sole or even principal factor in a transaction, but rather that business considerations should dominate.

Any line which depends on a necessarily imprecise weighing of tax versus business considerations will produce transactions the desirability of which depends on one's appraisal of the policies underlying the rule itself. On the one hand, the tax law has always permitted loss corporations to revitalize themselves by investing their capital in profitable new businesses. On the other, "trafficking" in tax losses is to be abhored. Professor Ginsburg's testimony describes a partnership transaction which, with a slight alteration of the facts, nicely illustrates the point. A joint venture is formed between a loss corporation and a profitable one, with the profitable business being contributed to the joint venture. Income is disproportionately allocated to the loss corporation for the first five years, after which time most of the income is allocated to the profitable corporation. Income is credited to capital accounts, but, in the case of the loss corporation, is not paid out in cash until some future time. Since capital accounts govern the economics of the joint venture, the allocations have economic effect—that is, allocations of taxable income are matched, dollar for dollar, with distributions of cash. Since the cash is distributed years after the income is allocated, however, the substantiality of the economic effect is questionable. In Professor Ginsburg's example, the cash is not distributed for twenty five or thirty years; in present value terms, the economic effect of the allocation is small and the tax effect large, and the allocation is clearly invalid. But where to draw the line? Recently consumated transactions pay "interest" on the loss corporation's capital account—say at a 7 percent rate—and continue to credit it with a potentially significant share of the profits of the venture. Suddenly the economics of the transaction look more substantial, and the weighing process becomes more difficult.

The Treasury Department is currently struggling with this precise problem. This sort of line drawing is the appropriate stuff for the regulations process. Congress has articulated a standard—substantial economic effect—which is consistent with the general policy governing the utilization of tax benefits by taxpayers not directly responsible for producing them: as long as business considerations are in the forefront, tax benefits may follow. A statute cannot—and should not—be drafted to cover every case. I think that the substantial economic effect standard represents the correct policy and should not be changed. Finetuning a policy that has been in the law for years is the job of those who interpret the law. The Treasury should be permitted to complete its regulations. There is no need for Congress to do more.

Chairman PICKLE. Thank you, Mr. McKee.

I was going to ask if we had a written statement from you but my staff says we do. I am sorry I did not have it before me as you testified.

Both of you gentlemen, particularly you, Professor Ginsburg, seem to say that this committee of the Congress should not do anything about mergers and acquisition matters. In effect, we should not try to take action.

Is that essentially your position?

Mr. GINSBURG. One hates to answer a question of that sort with a yes or no. You are in serious trouble if you do.

I guess what I am saying, Mr. Chairman, is that listening to all of the concerns that have been expressed, some of which I think are very real and appealing, I do not see where these problems are problems that should be reacted to in the tax law other than in a much more encompassing way.

In 1982, and to a lesser extent in 1984, there were problems that I think were explicitly problems in the tax law, although my own view was that most of them were in the consolidated return regulations. But it was understandable that the committee decided to react to particular abuses that it could target on and say, yes, I have looked at transaction X and it is a terrible piece of business as a tax law matter. I do not think that what we are dealing with today is of this quality. I think today's problems are very different kinds of problems.

Chairman PICKLE. Well, we have a difficult time knowing just how to approach these matters, and none of us take pleasure in passing another tax reform bill or another tax measure. But I take it that what you are saying, and to a more limited extent, Mr. McKee, is that we have got so much tax law now that we do not need any more and, therefore, should not fool with this. That is what you said at the beginning. You say it really is too much, we ought not to do it. And then you proceeded for 31 pages to tell us things we ought to be concerned about.

Mr. GINSBURG. That is the problem of being a pedagogue. You get carried away when you face blank pages.

Chairman PICKLE. That is the advantage of this chair. I can make that observation. The role may be reversed a bit here. [Laughter.]

We are not trying to do away with the deduction of all interest. That constitutes a problem. We are trying to figure what can we do, but we are concerned that if we do nothing or do not look into this thing to see to what extent the Tax Code is being used, then we just allow these hostile takeovers or the friendly takeovers to proceed. And we do get into serious questions about debt and equity financing. We do get into serious questions about the protection of shareholders, particularly if we had a recession, or a depression, and we are trying to find some way to protect the individual in their investments. It bothers us.

While we do not know the answer, it is not enough for us to say it is too complicated and, therefore, let us look at something else. That is what bothers me.

Mr. McKee, you look a little itchy. Did you want to say something?

Mr. MCKEE. Yes; thank you very much.

The problem is obviously not a new one. The Treasury Department in 1981 when it put safe harbor leasing in the code, gave as one of its principal justifications for safe harbor leasing the need to take pressure off of tax motivated mergers and acquisitions.

When we ran the numbers in 1981 preparing for that tax bill, we could see that without, or the Treasury could see that without doing something, the system would accumulate tens and tens of billions of dollars of unused deductions and credits in the corporate sector, and safe harbor leasing was a way to take the pressure off.

As I mentioned in my statement, there still are other ways to take the pressure off. Partnerships are one and the old leveraged leasing technique is there. But the pressure on tax motivated transactions exists because the tax system has been used to provide substantial stimulants for capital investment through ARCs and investment credits. As long as those stimulants are there, you are going to have these problems. And what Professor Ginsburg and I are saying is that you are not going to be able to solve the problem in the merger and acquisition area by making simple cosmetic or technical changes.

As long as you have that volume of investment incentives in the system, people are going to find ways to use it. They are going to structure transactions to take advantage of those tax incentives, and the economic consequences of so doing are obviously not pleasant to contemplate. You do get noneconomic transactions.

An old saying is that if you do not like the bees getting to the honey, get rid of the honey.

Chairman PICKLE. We are not trying to pass a technical quick-fix bill here. We would like to know what can be done in the wisest way we can approach it. If you have any recommendation or suggestion on that, we would like to have it.

Now, I have looked at some of your testimony, but I have not had a chance to look through it all. I would assume that we could give some consideration to some changes perhaps in sections 337 and 338. We thought 2 years ago it might be of some help. We might want to make some changes to them.

You also mentioned section 269. That would deny tax benefits to mergers undertaken primarily to secure tax benefits. In your opinion, has section 269 worked well to stem these mergers and acquisitions taken for tax purposes?

Mr. GINSBURG. No; I would like to say I believe it was Mr. McKee who referred to section 269 in his oral testimony. You are quite right, Mr. Chairman, that I referred to it in my written testimony, and I borrowed from my friend, Donald Shapiro, and referred to it as the "blind policeman of the tax law," but I think I intended to suggest it really does not work very efficiently and it is not the rule I would want to follow.

Your reference to section 337 and 338, that is a much more fruitful affair, of course, and I think it is directly responsive to a point Mr. Martin made when he testified earlier, his concern with the stepped-up basis and redepletion of the assets. I tried to address that in my written testimony.

The problem is not, I think, that the buyer, having paid money for something, gets a basis he can depreciate. It is, as I believe you were suggesting, that the seller is not paying the tax on the sale,

on the profit that is being made in that transaction. But, again, as I tried to suggest in the written testimony, it is not a matter that one can address in an easy way. The issues there get to be fairly turbulent and they are very important issues.

Chairman PICKLE. They are, and we do not know what the answer is. It does concern us to hear that a raider can make $500 million, and I have a feeling when you look at the tax returns that the Treasury will not realize the tax value because the profit is going to be invested or sheltered. Then what do we use to run the Federal Government with? That has to be a concern of ours.

Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman. I appreciate that.

Gentlemen, I appreciate very much your testimony. We have had recommendations before the committee today, and on other occasions, that we should look very carefully at section 338 and perhaps deny the deductibility of interest on junk bonds, and other suggestions as to how to deal with this problem.

Let us assume for a minute that we did that. Do you believe that that would be effective in curbing these mergers and acquisitions, or would gentlemen, such as yourselves, and other experts in the tax bill, be able to find equally effective means of accomplishing the same thing?

Mr. GINSBURG. No to the first, and yes to the second. No, it would not be effective, and, yes, as I think I once said at one of these hearings, the tax bar is a repository of the greatest ingenuity in America. If you give them the opportunity, they are going to do you in. They will continue to do that.

Mr. FLIPPO. Because if we did those targeted things, we are really not dealing with the generic problem. If I understand your testimony correctly, that in essence it is this difference in taxation between debt and equity, and the tax of an integrated system and some other things, that is the overall means of looking at the problem that would provide a solution.

Mr. GINSBURG. It is a great combination of complex interactions, but I think the bottom line is exactly what Mr. McKee said. You have made the game very attractive and, therefore, people will play it.

Mr. FLIPPO. Let me ask either of you if you would help us understand a little better about whether or not a foreign entity has available to it some tax incentives that a U.S. person does not have in the area of mergers.

In other words, we see that it appears that the tender offer for Crown Zellerbach is being played through the use of a foreign partnership. I am wondering if you could help us understand, does the Tax Code provide tax incentives to foreign persons, that are not available to U.S. persons, in the area of mergers?

Mr. GINSBURG. I am not sure how well I am going to do with that. I notice that Professor Eustice is going to be testifying later.

Mr. FLIPPO. I am sure you will do better with the answer than I will with the question.

Mr. GINSBURG. Whenever you cross national boundaries in a tax planning situation, you encounter both a series of sort of geometrically complicating problems, and also marvelous opportunities.

For some period of time, as an example, there have been arrangements involving British acquiring companies, where properly structured, using levered financing, debt financing, you can actually deduct the interest in both countries.

If that is what you have in a particular case, the acquisition is extremely attractive, because if you are avoiding taxes at, say, 40 or 50, or whatever percent, in two different places, it is very inexpensive to make this acquisition. That is not, however, I think, in that case, a creature of our tax law. That is a peculiarity of the British tax law, and one which I understand they are about to fix up.

I do not really have any general answer to the question that you have asked.

Mr. FLIPPO. Now, I want to go back to the first subject we talked about, and make one comment, our inability to target solutions to specific areas, and dealing with them in general terms.

I believe your response was that we make this very lucrative, or the Tax Code makes it very lucrative, and people are going to deal in this area because of the impact on taxes.

Would you agree then that a reduction in the rate of tax would make it less lucrative, and therefore, tend to slow down these mergers and acquisitions?

Mr. MCKEE. Yes, I think certainly to the extent that you have a tax system that delivers subsidies through deductions, to the extent that the marginal rate is less, the subsidy is less.

The real answer, of course, is to get rid of the subsidies.

I note that the Joint Committee's tax expenditure budget for next year is over $400 billion. As I keep telling people, the tax system is apparently not designed to raise money. It is designed to spend it, because we spend more than we raise. And despite the protestations to the contrary, that it is designed to raise money, if you look at the numbers, it is not doing what it is supposed to do.

As long as we continue to spend more than we raise through the tax system, I will continue to tell my clients that they are trying to give the money away, and you ought to step up to the plate and get your share.

Mr. FLIPPO. I appreciate your testimony today, and the completeness of your written testimony, and I think it will steer us in the right direction.

Thank you very much.

Chairman PICKLE. Mr. Frenzel.

Mr. FRENZEL. Thank you, Mr. Chairman.

Thank you, gentlemen, for your testimony.

Both of you would advise us not to pass the Jones bill?

Mr. GINSBURG. I would.

Mr. MCKEE. I agree, correct.

Mr. FRENZEL. Both of you would advise us to do nothing in the Tax Code to prevent the kinds of acquisitions which the committee may or may not find offensive, or at least the ones that offend Mr. Jones. Would you prefer we not use the Tax Code to deal with that problem?

Mr. GINSBURG. I would prefer that you not use the Tax Code to attempt to deal discretely with that problem, or any similar prob-

lems. It is just that in the end it does not work very well, if it works at all, and you constantly have to come back and redo it.

We seem in the end not to solve problems in the tax law. We trade problems in the tax law.

Mr. FRENZEL. Mr. McKee.

Mr. MCKEE. I agree with Professor Ginsburg.

I do hope you have time this year to fix section 382, and similar provisions, in need of technical work, but other than these cases, the whole thrust of what we have been hearing recently about fundamental tax reform is an effort to take the Internal Revenue Code back to the days of yesteryear, when it was designed to raise money, not spend it. Certainly all of the efforts to have a broad based, low rate income tax go in exactly the opposite direction than that of the Jones bill. The efforts are designed to take the Tax Code out of the business of influencing economic behavior, and to try to make it as neutral as possible.

I agree with Professor Ginsburg that these small little fixes, where we go in and tinker with the Tax Code to try to solve one tiny problem, generally result in problems showing up somewhere else that we did not think about when we did the fix. We are usually sorry we did it.

Mr. FRENZEL. Do you suppose we will be as lucky in eliminating a tax preference, as we have been in controlling our spending? [Laughter.]

Would either of you want to make a recommendation as to whether Congress should do anything about the problem that concerns Mr. Jones?

Mr. GINSBURG. If the question is whether some other committee than a tax writing committee should be addressing these matters, I do not have the competence to respond to it. But I am convinced that if somebody should be addressing these problems, it ought not to be here.

Mr. MCKEE. I agree with that.

Mr. FRENZEL. This is not your business, particularly?

Mr. MCKEE. That is correct.

Mr. FRENZEL. You refer not to make a recommendation?

Mr. MCKEE. As a citizen, I am perfectly happy to say I am in general for a less government, more free enterprise type of an approach to the problem, but I have no particular expertise, so why should you listen to me, any more than you ought to listen to any one of the other 200 million citizens of the country?

Mr. FRENZEL. That is the sort of business we are in. We get an awful lot of free advice from a lot of people. You might as well get on the bandwagon.

Mr. MCKEE. I give you my vote.

Mr. FRENZEL. Running through the testimony that we are receiving, there is a pretty heavy vein of counsel telling us that we will disrupt the market if we get in here and stick our fingers in some place where we are not certain of the results.

At any rate, I think your testimony will be very helpful to us as we begin our chore in tax reform.

I am delighted that both of you have such high hopes for us. Perhaps they will be realized.

Thank you very much.

Chairman PICKLE. Mr. Anthony, or Mr. McGrath?

[No response.]

Chairman PICKLE. Before you gentlemen leave, let me make this observation.

First, let me ask you—I think Professor Ginsburg said in his testimony that the tax laws should be neutral. Do you think they are neutral now?

Mr. GINSBURG. No.

Mr. MCKEE. No.

Chairman PICKLE. We asked one of the witnesses 2 weeks ago if he thought they should be neutral, and he said no. This was Mr. Pickens. We were not trying to pick on Mr. Pickens.

He said, oh, no. He admitted the tax law, in effect, favored him, and he did not want it to be neutral. So if our tax laws should be neutral, then I would ask you what changes should we make, where, how, and in what area?

I do not want to have a dissertation on it, but you might just mention a few areas.

Mr. MCKEE. Certainly the Treasury's proposal is a good starting point for looking at what directions the committees ought to be going in. I would caution that the one concern that I think that everybody has, is that if you do not provide adequate transition rules to move from the system in which—as I have said before, the system right now spends more than it collects—substantial economic damage could occur.

We have a tax system that is massively intruding on everyone's lives. It tells companies what to invest in, what not to invest in. That is what I do in my professional life. I tell people what to do and what not to do, because you all have written a Tax Code that gives them incentives as to what to do.

Chairman PICKLE. Professor, you do not have to worry about us having a liberal transition rule. We always do. That is the price of any change of the Tax Code.

Mr. MCKEE. I think that is true, but in this particular case there are a lot of transition rules in the original Treasury proposal that were certainly not generous at all.

What I am suggesting is that a shift of this magnitude, the elimination of $400 billion worth of tax expenditures overnight, or fairly quickly, has to be done with some caution, but clearly that is the direction we have to go in. It is to look at the tax expenditure budget that you all have prepared for you, and try to get rid of all of them.

Chairman PICKLE. I certainly agree with you. You got my attention when you observed that we have some $400 billion in tax incentives that we give away, and with that much floating around everybody is going to try to get their hands on it, and they sure do.

How do we change that, when we have $400 billion going out, and we have a budget of about $930 billion? It is a losing proposition. We need to make some changes.

More specifically, down to the problem at hand, if the Tax Code in these areas is not neutral, can we make changes in the stepped-up basis, the deduction areas?

Are those some of the areas we could look at?

Mr. GINSBURG. Surely. I think the concern is not with the stepped-up basis. The concern is that the Government is not getting adequate tax, a proper toll charge, in order to allow that basis step-up. That is generally called in our business the general utilities problem, and you have been nibbling away at it for 30 years. With any luck at all, in a true tax reform effort you would sensibly get rid of the thing.

[The following was subsequently received:]

COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC, May 13, 1985.

MESSRS. GINSBURG AND MCKEE: Thank you for appearing as a witness at the Subcommittee's hearing on mergers and acquisitions. Your experience and expertise provided the Subcommittee with much valuable analysis and information. For the purpose of completing the Subcommittee's hearing record, I have enclosed a series of additional questions for your response.

I would appreciate your review and response to my office by May 24, 1985. If you have any questions, please contact Bill Cunningham of the Subcommittee staff at 225-5522.

Sincerely yours,

J.J. PICKLE,
Chairman, Subcommittee on Oversight.

Enclosures.

1. Do you feel that the tax laws encourage mergers? If so, which provisions are primarily used by the parties involved in mergers? Should the tax code the neutral toward mergers? If yes, which provisions of the tax code should be changed and how?

2. Some experts argue that a firm is vulnerable to a takeover when (1) stock is undervalued in relation to its underlying assets; (2) the corporation has a high effective tax rate; or (3) the corporation has substantial liquid assets, including an overfunded pension plan. Do you agree? What other characteristics of a corporation make it an attractive takeover target?

3. Some experts argue that the tax laws encourage debt financing rather than equity financing since corporations are allowed deductions for interest payments but not for payment of dividends.

(a) Do you agree?

(b) Should the Congress restrict or eliminate the deductibility of interest (1) generally; (2) in all mergers; (3) in "hostile takeovers"; or (4) for "junk bonds"? Please explain.

4. If a line were to be drawn for tax purposes between friendly mergers and hostile mergers, how should hostile be defined? Should a vote by the "independent directors" of the target corporation be determinative? If not, what test or standard should we use? Should the tax code distinguish between hostile and friendly mergers?

5. If the deduction for interest payments on junk bonds were denied, do you feel that such denial should apply:

(a) To all junk bonds;

(b) To junk bonds used in connection with any merger or acquisition;

(c) To junk bonds used in connection with any large merger or acquisition;

(d) To junk bonds used by any target company to repurchase its own stock.

Please explain your answer.

6. How would you define a "junk bond" for tax code purposes? Are there other debt or equity instruments with similar characteristics to those of junk bonds that we should be concerned about in evaluating the deductibility of interest?

7. Does the election under Section 338 of the Internal Revenue Code to step up the basis of assets cause mergers to happen or does it instead influence the form of the merger?

8. What impact would a repeal of the Section 338 election have on mergers? Would it decrease the number of mergers and/or affect the terms of some mergers such as pricing?

9. Do you feel that any changes should be made to Section 336, Section 337 or Section 338 of the Code? If so, what would you recommend?

10. Some experts argue that certain mergers are driven by profitable corporations seeking to offset their income by acquiring firms with net operating losses. Should

the Congress address as a priority modification of Section 382 of the Code? If so, what recommendations do you have?

11. Should greenmail payments be prohibited or penalized? If so, should such regulation be done through the securities laws and/or the tax laws? Do you have any recommendations for regulating greenmail payments through the tax code? How would you define "greenmail"?

12. Should corporations making greenmail payments be allowed to deduct those payments in whole or in part as ordinary and necessary business expenses?

GEORGETOWN UNIVERSITY LAW CENTER,
Washington, DC, May 31, 1985.

Hon. J.J. PICKLE,
Chairman, Subcommittee on Oversight, House Ways and Means Committee, Longworth House Office Building, Washington, DC.

DEAR CONGRESSMAN PICKLE: As requested in your letter of May 13, 1985, this responds to the series of additional questions you have asked concerning the tax treatment of mergers and other corporate acquisitions.

A number of the questions raised in your letter of May 13 were addressed, at least in part, in the written statement (dated April 2, 1985) I submitted to the hearing on corporate mergers and acquisitions at which I testified on April 16. To avoid repetition to the extent I can, in my responses I will refer to the written statement.

I have taken the references in your letter to "mergers" to encompass all forms of corporate acquisitions and combinations, whether accounted for under the tax law as reorganizations or as purchase transactions.

1. Do you feel that the tax laws encourage mergers? If so, which provisions are primarily used by the parties involved in mergers? Should the tax code be neutral toward mergers? If yes, which provisions of the tax code should be changed and how?

Current tax law, in a great many cases, encourages mergers. A principal purpose of the written statement was to identify the concepts and provisions of current law that seem to me to lead to this result. As stated there, particularly in ⟨ IV, the tax law ought to be neutral, as nearly as feasible, in business and investment decisions of this sort.

How that tax neutrality might be achieved is a complex question and I have tried to address it in the written statement. It is in part complex because apparent issues often are not the real issues. Perhaps the clearest example is the deductibility of interest by a corporation that has debt financed its acquisitionof another corporation. Without question the substitution of deductible interest for nondeductible dividend distributions lends attraction to the leveraged corporate acquisition. But the tax concern is not limited to, and a sensible resolution of it cannot concentrate on, corporate acquisitions. As a tax matter the real issue is no different if the acquisition is financed out of the buyer's retained earnings, and it is no different if what is acquired is stock of the buyer itself (a redemption or going private transaction) rather than stock of a different corporation.

I will return to this subject in my response to Question 5.

2. Some experts argue that a firm is vulnerable to a takeover when (1) stock is undervalued in relation to its underlying assets; (2) the corporation has a high effective tax rate; or (3) the corporation has substantial liquid assets, including an overfunded pension plan. Do you agree? What other characteristics of a corporation make it an attractive takeover target?

I agree as a matter of common understanding, laying no claim to expert judgment on takeover vulnerability.

Viewed from the prospect of the tax law, a corporation is an attractive takeover target, when the form of takeover is a "purchase" for tax purposes and thus allows a stepped-up asset basis, when (1) the target's assets are appreciated in value substantially above tax basis, (2) that appreciation is not subject to taxable "recapture" in significant part, and (3) in the hands of the purchasing corporation (or purchasing corporate group) the stepped-up asset basis will generate substantial tax benefits, for example through depreciation or the avoidance of gain when the acquired assets are promptly disposed of. This matter is addressed at greater length in the written statement, mainly in § III B.

3. Some experts argue that the tax laws encourage debt financing rather than equity financing since corporations are allowed deductions for interest payments but not for payment of dividends.

(a) Do you agree?

Yes. I would add that the tension is dominantly between debt financing and new equity investment. Present tax law exhibits a strong bias in favor of debt invest-

ment as compared with new equity investment because interest is deductible (dividends are not) and debt repayment is not dividend income to the recipient while in some circumstances a stock redemption will be treated as a dividend to the shareholder. The same tension does not exist when the choice of financing is between retained earnings and borrowed money, largely because current tax law incorporates biases in favor of accumulation and in favor of nondividend distributions (e.g., payments out of corporate solution that are not taxed as dividends to noncorporate sellers of corporate stock), and a bias against dividend distributions out of corporate solution. These biases offset the system's bias in favor of debt financing.

(b) Should the Congress restrict or eliminate the deductibility of interest (1) generally; (2) in all mergers; (3) in "hostile takeovers"; or (4) for "junk bonds"? Please explain.

I do not believe Congress should do any of these things. The determination to disallow an interest deduction to a subchapter C corporation logically proceeds from a threshold conclusion that the "instrument" on which the payment is made is not, in the tax sense, truly "debt" at all. Rather, the threshold determination is that the instrument is disguised equity and, to protect the separate (nonintegrated) corporate tax base, current law does not allow a deduction for distributions on corporate equity. All of this, of course, forces the Commissioner and the courts to undertake an exercise in classification, distinguishing "true" debt from disguised equity, an unsatisfactory state of affairs that led to the enactment of not very satisfactory § 385.

If Congress were minded to address the issue, I believe it should do so in a way that defuses the classification problem (the restrictions suggested in Question 3(b) would exacerbate rather than avoid the problem). The Reporter's Study contained in the American Law Institute's Subchapter C Report (Federal Income Tax Project 1982) points the way. Revised tax law could, for example, allow (and limit) a corporation to deduct distributions (whether denominated interest or dividends) each year equal to, say, 10% of the sum of (1) invested capital (aggregate shareholder investment in the corporation, not previously returned, measured by basis at the time transferred to the corporation), plus (2) the corporation's average indebtedness (issue price) during the year. In that revised corporate tax world, stock redemptions aggregating invested capital would not be taxed as dividends, but stock redemptions in excess of total invested capital would require payment of tax appropriate to dividend distributions. In all of this, it would make no difference whether a corporation's indebtedness, or indeed its equity capital, arose in normal operations or in a takeover, whether friendly or hostile.

4. If a line were to be drawn for tax purposes between friendly mergers and hostile mergers, how should hostile be define? Should a vote by the "independent directors' of the target corporation be determinative? If not, what test or standard should we use? Should the tax code distinguish between hostile and friendly mergers?

A line or distinction of this sort rationally can have nothing to do with the tax law. Defining "hostility" may be a task for psychiatrists, but not for tax people.

5. If the deduction for interest payments on junk bonds were denied, do you feel that such denial should apply:

(a) To all junk bonds;

(b) To junk bonds used in connection with any merger of acquisition;

(c) To junk bonds used in connection with any large merger or acquisition;

(d) To junk bonds used by any target company to repurchase its own stock.

Please explain your answer.

I would not deny an interest deduction on "junk bonds" merely because corporate indebtedness is awarded that label. As indicated in the answer to Question 3(b), in a different tax world that restricted annual deductions to a specified percentage of total invested capital plus indebtedness, the higher the ratio of junk bonds to equity investment the more likely it would be that a portion of the "exorbitant" interest payment is disallowed as a deduction. But the specific characteristics of the instrument and its label, whether "junk bond" or bank debt, would be irrelevant.

It would be equally irrelevant whether indebtedness, junk bond or any other, were incurred in connection with a small merger, a large acquisition, or a going private (redemption) transaction.

As a matter of tax law—current or projected future—I do not think it proper to distinguish between indebtedness incurred to redeem stock of the debtor and indebtedness incurred by one corporation to purchase the outstanding stock of another. In each case, when the selling stockholder is an individual, because the corporation has incurred an obligation to pay deductible interest in future years the burden of the corporate tax has been lifted from an equivalent amount of corporate income. But exactly the same result obtains when the corporation makes the acquisition using

retained earnings. Future corporate taxable income is reduced by the yield those retained earnings would have generated, in the business or in the bank, had no merger or redemption occurred. And certainly the acquiring corporation, having expended retained earnings, later may replace the funds by borrowing new money. In sum, I can see no basis in tax law to distinguish junk bonds (or non-junk bonds) issued in one transaction or in another.

6. How would you define a "junk bond" for tax code purposes? Are there other debt or equity instruments with similar characteristics to those of junk bonds that we should be concerned about in evaluating the deductibility of interest?

I would not define "junk bond" for purposes of the tax law. So long as the tax law continues to distinguish between debt and equity, in terms of the deductibility of yield payments, the tax law will be concerned with a number of categorizing characteristics. It is not at all clear, however, that these are or ought to be "similar characteristics to those of junk bonds."

7. Does the election under Section 338 of the Internal Revenue Code to step up the basis of assets cause mergers to happen or does it instead influence the form of the merger?

I do not believe § 338 causes mergers to happen, but the availability of that provision will influence the form of corporate acquisition.

8. What impact would a repeal of the Section 338 election have on mergers? Would it decrease the number of mergers and/or affect the terms of some mergers such as pricing?

Other than affecting the form of transactions, I do not think a repeal of ⟨338 would have any measurable impact on the identity or volume of business combinations. It is not even clear that repeal of § 338 would affect pricing.

We ought to ask, "and then what?". If § 338 is repealed, will Congress reinstate—as almost certainly it must—pre-TEFRA law, "old" ⟨334(b)(2), or something like it? If so, Congress will be reopening the loophole—stock purchase by an affiliated corporate group enjoying a large consolidated loss carryover—that the 1982 Act was designed to close. That might increase the number of mergers. Certainly it would not decrease the number.

9. Do you feel that any changes should be made to Section 336, Section 337 or Section 338 of the Code? If so, what would you recommend?

Absolutely. The written statement is devoted largely to this question. Sections 336 and 337 should be repealed, corporations should recognize gain on any transfer of appreciated property in which the basis of that property will be stepped-up in the hands of the transferee, and the only significant questions are whether and in what circumstances and in what fashion should the tax law afford the corporation's historic shareholders relief from the impact of double (corporate and shareholder) taxation.

As to § 338, the repeal of § 337 would make it clear that each dollar of asset basis step-up triggers a dollar of recognized (taxable) gain to the target corporation. In that world there would be no need (as in truth there is little need under present law) for the § 338(e) consistency requirement that has turned ⟨338 from the simple elective regime it was intended to be into a nightmare of complexity.

10. Some experts argue that certain mergers are driven by profitable corporations seeking to offset their income by acquiring firms with net operating losses. Should the Congress address as a priority modification of Section 382 of the Code? If so, what recommendations do you have?

I have attempted to address the loss corporation issue, at least in part, in § I of the written statement. My recommendations are focused mainly in a series of questions set out in the last five paragraphs of § I of the written statement.

11. Should greenmail payments be prohibited or penalized? If so, should such regulation be done through the securities laws and/or the tax laws? Do you have any recommendations for regulating greenmail payments through the tax code? How would you define "greenmail"?

As a matter of tax law I would not attempt to define "greenmail" and I would neither penalize nor reward it. If greenmail is inconsistent with the federal securities laws, it ought to be dealt with there.

12. Should corporations making greenmail payments be allowed to deduct those payments in whole or in part as ordinary and necessary business expenses?

A corporation making greenmail payments, like a corporation making non-greenmail payments, in redemption of stock should not be allowed to deduct those payments. Of course, when the stock issuance and later redemption simply measure employee compensation, under § 83(h) payments ought to remain as deductible as cur-

rently they are, not more or less. But stock redemptions of that sort have nothing to do with greenmail.

Sincerely,

MARTIN D. GINSBURG.

KING & SPALDING,
Washington, DC, June 5, 1985.

Mr. BILL CUNNINGHAM,
Committee on Ways and Means, Subcommittee on Oversight, House of Representatives, Washington, DC.

DEAR MR. CUNNINGHAM: I apologize for not having responded to Chairman Pickle's letter to me of May 13, 1985, dealing with questions and answers arising out of the Subcommittee's Hearings on mergers and acquisitions.

As you may recall, I appeared at the Subcommittee's invitation to discuss the impact of partnership taxation on the merger and acquisition problem. The questions contained in Mr. Pickle's letter deal with the topics covered by my co-panelist, Professor Martin Ginsburg. Unless you have some questions which relate to my particular area of expertise, I will be satisfied with whatever responses Professor Ginsburg makes with respect to these questions.

If you have any questions you would like directed to me in particular, please do not hesitate to give me a call.

Thank you very much.

Sincerely yours,

WILLIAM S. MCKEE.

Chairman PICKLE. Professor, you kind of come back to where you started. I think we are ending up on a positive note. You started off by saying we ought not to do anything, but you say there are three or four areas that we ought to look into to. So maybe we made some progress today.

Mr. FLIPPO. Would you yield for a clarification?

Chairman PICKLE. Yes.

Mr. FLIPPO. The gentleman made the statement that the Tax Code spends more money than it collects. You were referring to the corporate area only, I assume?

Mr. MCKEE. No; I am referring to the Joint Committee's tax expenditure budget, which shows that we are spending more through taxes we do not collect, on purpose, to influence behavior than what we get out of individuals.

I am a year behind in my numbers, but for fiscal 1984, individual tax collections were about $294 billion, and the tax expenditure budget was about $330 to $335 billion.

Mr. FLIPPO. Today our income Tax Code collects somewhere in the neighborhood of $800 billion and if the tax expenditures are $400 million——

Mr. MCKEE. I do not count Social Security taxes. I am just counting income taxes, focusing primarily on individual taxes. But even if you include the corporate tax, I think the fiscal 1986 budget for tax expenditures exceeds both individual and corporate collections. I also do not count in my numbers excise taxes, such as telephone taxes and transfer taxes, and the second biggest source of collections, Social Security taxes on wages.

Mr. FLIPPO. Whatever they are, they are too much in this day and time.

Mr. MCKEE. They certainly are.

Chairman PICKLE. Thank you both very much. We appreciate your testimony.

We will now call the next panel. Mr. Joseph Schuchert, Mr. Gerald Peck, Mr. Jack Twyman, and Mr. Robert Harbrant.

Mr. FLIPPO [presiding]. Thank you for appearing before the committee, and your statements will be filed for the record in total.

It is a pleasure to have you with us, and please proceed as you deem appropriate.

STATEMENT OF JOSEPH SCHUCHERT, MANAGING PARTNER, KELSO & CO., NEW YORK, NY

Mr. SCHUCHERT. My name is Joseph Schuchert. I am managing partner of Kelso & Co., an investment banking firm specializing in leveraged buyouts, generally utilizing employee stock ownership plan corporate financing techniques.

Kelso & Co. is the successor of the original organization founded by Louis O. Kelso in San Francisco, the acknowledged creator of the ESOP. One of the predecessor firms of Kelso & Co. effected its first ESOP which was structured as a leveraged buyout of Peninsula Newspapers in 1954. Since then, in over 700 transactions, the Kelso organization has been in the forefront of developing innovative ESOP financing techniques.

The press release announcing these hearings indicated that the subcommittees are seeking information on the ways in which the tax laws influence merger and acquisition decisions and the extent to which present law may act as an incentive for these transactions. With regard to these issues, I will generally limit my comments to the area of leveraged buyouts.

I cannot say with certainty the motives or factors that entered into decisions concerning some of the more celebrated transactions which have been recently reported in the news. However, based on many years as a practitioner in corporate finance, it is my belief that tax considerations standing alone are not the driving force for most of these transactions. In the experience of Kelso, acquisition transactions--mergers, sales, and buyouts--result from economic opportunities which present themselves because of business and market conditions. The business reasons vary from the need for expansion, to acquire additional or new technological capability, to enhance distribution or marketing, or to diversify. Further, many reasons stem from market conditions and the failure of the present public stock market to fairly reflect the true underlying values of the stocks of public corporations.

So that the major question to be answered in evaluating acquisition opportunities is whether or not the long-term business objectives of the firm can be obtained more effectively by acquisition than by internal development. Thus, it is our belief that only after considerable business and financial analysis are these transactions undertaken.

Taxes are definitely considered in the analysis and certainly influence the decisionmaking process, most often the structure of the transaction. I can say that taxes, at least in the buyouts with which Kelso has been involved, did not drive the transaction.

LEVERAGED BUYOUTS

A traditional leveraged buyout, which we now call an LBO, involves the purchase of assets or stock of a public or private company, or the purchase of a subsidiary or division of either, substan-

tially with debt extended to the buyers based on the operating prospects of the business acquired, with a moderate amount of equity investment. As in the case of other mergers and acquisitions, the experience of Kelso & Co. indicate that leveraged buyouts are motivated primarily by economic and business considerations.

Some commentators have raised the question whether the ability to deduct interest charges associated with a debt-financed acquisition is the major reason buyouts take place. I do not think so. The chief consideration in an LBO analysis is whether the cash flow and earnings of the new company will be sufficient in amount and over time to retire the debt incurred and to meet other financial responsibilities of the firm. A great many factors are considered. For example, the firm's market position, future sales projections and the like. Obviously, again tax considerations are very important in the final structure of the deal, for example, the tax considerations associated with ESOP's. Any reduction in taxes which would otherwise be incurred could improve the feasbility of the buyout, but the deductibility of interest charges or contributions to an ESOP is not a controlling factor.

LEVERAGED BUYOUTS AND ESOP'S

Essentially, an employee stock ownership plan, or ESOP, is a tax-qualified plan under which employer stock is held in trust for the benefit of employees. The stock, which is held by one or more tax-exempt trusts under the plan, may be acquired through direct employer contributions of stock or cash or with the proceeds of a loan to the trust. Contributions to an ESOP, whether in the form of stock or cash, are deductible by the employer, as are contributions made to any other qualified employee benefit plan. If stock is contributed, its value is the deduction. If the ESOP borrows to purchase stock, employer cash contributions may be used to repay the loan, and such contributions are deductible. It is this latter type of ESOP which borrows to acquire employer stock that is referred to as a "leveraged ESOP."

The ESOP represents a technique of corporate finance. That also serves as a new type of employee benefit. As a tax-qualified plan for providing employee benefits, in the form of employer stock, an ESOP is subject to many of the same standards imposed on other types of employee benefit plans but interpreted in light of its unique purposes.

For example, the plan must meet certain minimum requirements with respect to the ownership of employer securities and concerning employee eligibility, participation, vesting and plan reporting and disclosure. In addition, distributions to employees receive the favorable tax treatment available to other types of qualified benefit plans. After the purchase of stock by an ESOP trust for a note, the stock is held in an escrow account for allocation to employees' individual ESOP accounts as the loan is repaid. In no sense is this a gift to employees; rather, the capital is paid for out of the future earnings that the company itself generates.

The ESOP participants, however, also earn their ownership interest in the company through the ESOP's requirement that employees work for the company for a prescribed period of time before

the stock in their ESOP accounts becomes nonforfeitable—that is, vested. In this regard, employees incur no out-of-pocket costs for allocated stock.

The ESOP's primary purpose, however, is not to serve as a retirement vehicle, but rather to serve as an incentive for corporations to structure their employee benefit and financing plans in such a way that employees can gain an equity, that is, ownership interest in the companies for which they work.

I have included in my written testimony an example of how this works with respect to the deductibility of payments to an ESOP trust in paying off acquisition debt.

By enabling a company to expense its capital investment, the ESOP lowers the sponsor company's costs and increases its available capital for other purposes. The same dollar that finances the company's capital requirements also finances an employee benefit in the form of employer stock. In comparison with conventional debt financing, ESOP financing broadens capital ownership. As the company grows, each employee's stock also appreciates in value, and when this benefit is received by the employee, it is taxable to him.

Leveraged ESOP financing may also be used to finance a merger, acquisition or divestiture. For example, at his confirmation hearing before the Senate Finance Committee, former Treasury Secretary Donald Regan explained how Merrill Lynch & Co. used an ESOP to divest itself of the Lionel-Edie Co. Rather than sell the company to someone else, the former chief executive explained:

> We used an employee stock ownership plan, letting them buy it, and they have prospered as a result of that. I am definitely in favor of that.

The first known use of ESOP-type financing was in 1956 by the founder namesake of our firm, Louis Kelso. The transaction involved an employee buyout of a chain of California newspapers. Since that time, hundreds of transactions have occurred involving companies of all sizes, and both closely held and publicly-owned. Notwithstanding the widespread use of ESOP's, only in the last few years has the business world at large really begun to focus on the ESOP alternative.

In recent time, the term ESOP has become a popular term with different meanings for different people. The term has been misapplied to other employee benefit plans that invest in company stock, including many traditional profit-sharing plans. Others view ESOP as an alternative or substitute for a retirement plan. Many also believe ESOP's mean workplace democracy in which employee stockowners directly manage firms. However, in our judgment, these are incorrect views of this financing technique and employee benefit.

With regard to the specific focus of these hearings, in the recent past some major companies have examined ESOP plans as possible devices to fend off real or potential hostile takeover threats. The case of Dan River, a Fortune 500 textile firm, is illustrative and one which has been discussed in the media. Kelso and Co. was retained by Dan River as an adviser. Our firm would be happy to assist the subcommittees in fully understanding the nature of that transaction.

While Dan River and a few other cases have gained much attention, they are not representative of the primary purpose or use of leveraged ESOP financing. In the hundreds of cases that our firm has been involved with over the years, only a few would involve so-called hostile takeovers or defenses from hostile takeovers—I would also point out that the terms hostile or friendly are obviously very much relative terms--this is so, in part, because the attempted use of an ESOP in this way raises a number of legal requirements which are appropriately designed to protect the interests of employees.

For example, ESOP's may only be established with the sponsoring company's consent. All ESOP trusts must be established for the exclusive benefit of employees. Also, ESOP's as tax-qualified employee benefit plans are governed by trustees who are required to act prudently. These and other similar standards, we believe, are effective and reasonable requirements.[1]

Mr. Chairman, I believe underlying the recent attention given to ESOP's and ESOP financing is a much more basic issue. In the early stage of its development, the ESOP was associated with only small firms or with ailing companies to be used as a technique of last resort. Fortunately, for the employee beneficiaries of ESOP's this has changed.

Until recently, of the 500 to 1,000 or so majority employee-owned companies, only a handful had over 2,000 employees. The use of ESOP's today goes far beyond the limited and inherently risky objective of averting plant closings and saving jobs. In fact, an ESOP is not specifically designed to save jobs and cannot in and of itself shield a company from economic or business risks. Such an expectation is unwarranted and is contrary to normal business experience.

Today, many major profitable corporations are becoming substantially employee owned with their employees acquiring a valuable ownership stake as a result. Firms such as Lowes Stores, E-Systems, Inc., and BlueBell, Inc. are examples. ESOP financing offers these firms an attractive alternative to traditional debt-financing arrangements. From a larger public policy perspective, ESOP's also help broaden capital ownership and thereby provide an additional source of future income for employees that can supplement social security or retirement benefits.

We believe this growth and development is positive and healthy for our Nation and is consistent with the legislative intent of Congress. The legislative history of statutes regarding ESOP's is replete with references to the ESOP as a "technique of corporate finance" and as a "bold and innovative method of strengthening the free enterprise system which will solve the dual problems of securing capital funds for growth and of bringing about stock ownership by corporate employees."

ESOP's are not a panacea, but neither is the goal of broadening capital ownership a pie in the sky idea. ESOP companies are not

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[1] The Department of Labor, which shares supervision of ESOP's with the Internal Revenue Service, has promulgated many rules for the protection of employee beneficiaries. Generally, these rules are reasonable and appropriate; others are questionable. Although this subject is beyond the scope of these hearings, we will be happy to supply additional information on this matter.

immune from the competitive marketplace. Some companies may not succeed, but for business reasons unassociated with their ESOP. The success stores are many and they are the strongest argument that ESOP financing techniques be preserved as an effective financing alternative for economically healthy enterprises.

Kelso & Co. believes that ESOP financing offers a practical solution and alternative in appropriate situations. We also believe that ESOP's serve important objectives of public policy and merit your interest and support. Of course, we would stand ready to work with you to ensure that they are used for the purposes for which they were intended.

Thank you.

STATEMENT OF GERALD PECK, PRESIDENT, NATIONAL-AMERICAN WHOLESALE GROCERS' ASSOCIATION, PRESENTING THE STATEMENT OF JACK TWYMAN, EXECUTIVE COMMITTEE MEMBER AND PAST PRESIDENT OF THE NATIONAL-AMERICAN WHOLESALE GROCERS' ASSOCIATION; PRESIDENT AND CHIEF EXECUTIVE OFFICER, SUPER FOODS, INC., DAYTON, OH

Mr. PECK. Mr. Chairman, thank you for the opportunity to testify on behalf of the National-American Wholesale Grocers' Association, commonly referred to as NAWGA.

I am Gerry Peck, president of NAWGA, and I am here substituting for Jack Twyman, a wholesaler member. His statement has been submitted for the record and, if I may, I will summarize that statement.

NAWGA is a trade association, servicing wholesale grocery distributors. We provide technical, educational, and government services to 300 wholesale grocer members. These members operate 700 distribution centers nationwide, serving 150,000 independent grocery stores and food service establishments.

NAWGA members' annual sales volume is $43 billion, that is half of the Nation's grocery supplies moved through this type of distribution center. Members also employ 100,000 people.

The tax laws in our country have been used to implement economic policy and support broad public policy matters. We believe the tax laws will continue to be used to encourage economic activities judged to be in the best interests of our Nation.

We also believe that hostile takeovers oppose those best interests. Since hostile takeovers are a form of acquisition, we make a distinction here between hostile and friendly mergers or acquisitions. Friendly mergers and acquisitions are made with specific goals in mind for both parties, such as controlling distribution costs, improving productivity, gaining access to new technology, or gaining access to capital.

The net effect has been to strengthen wholesale service and support for our Nation's independent grocers and food service outlets. Consolidation through friendly mergers and acquisitions has helped to resolve problems such as management succession, the State tax planning and capital for expansion. It has provided economies of scale that help to keep food price increases lower than overall inflation rates.

Consolidation has intensified competition in a truly competitive industry, with after tax profits of less than 1 percent.

Current law provides the hostile takeover bidder with a distinct advantage. Typically, a corporate raider will acquire a small interest in a publicly held corporation. The raider then makes a tender offer, contingent upon financing. These offerings are financed by debt issued by the shell company controlled by the raider.

A two tier offer may be coersive to the target company's stockholders. The stockholders are given a cash premium in the first tier of the offer, and then in the second tier, after the raider is in control, the remaining shareholders must accept low-rated, high-risk debt obligations, referred to as junk bonds.

In order to protect their investment, shareholders are coerced into tendering on the first tier, or face the risk of being forced to accept the low-rated debt. The shareholder and the target company are usually at a disadvantage because of the speed in which all this occurs.

The raiders may spend months secretly preparing for the hostile takeover. The target, on the other hand, has only a few weeks in which to prepare a defense that will allow shareholders to make a rationale decision.

If the raider acquires the company, all or part of the company may be liquidated by selling assets to service the incurred debt. If the raider does not succeed in acquiring the target company, he can usually sell his shares back to the target company at a premium price. This is commonly referred to as greenmail, and it is at the expense of all other shareholders of the corporation. It is virtually a no-loss situation for the raider.

This preferred strategy of today's corporate raiders occur because gains are sheltered by the highly leveraged junk bond expense. At the same time, these writeoffs are not available on the same basis to a company interested in continuing for the long term.

Unlike friendly acquisitions, hostile takeovers are a serious misuse of capital. The cost of defending against a takeover attempt can cripple a surviving company, by burdening it with enormous debt, and this nonproductive debt can seriously jeopardize the financial soundness of another wise sound business.

There is more to the problem than dollars. There is also a human factor. When a raider company must dismantle corporate dividions to retire newly acquired debt, employees are let go. Also terminated are the longstanding relationships between the target company and local customers, suppliers, bankers, insurance agents, and so on.

There are other intangible losses. The civic responsibility that the community welcomes from good corporate citizens is lost. The losers are local charities, civic groups, and the arts.

What can be done. The Williams Act, whose ideal of a level playing field between the bidder and target could be amended to enforce its original intent. The bills before the Congress currently provide for increased disclosure of the bidders' goals and plans for the target company, and for the anticipated effect of a takeover on the bidder, the target, the shareholders, employees, creditors, suppliers, customers, and the community in which it operates.

These bills will also provide an approval process, requiring outside directors and/or shareholders of both the bidder and the target company, to approve a takeover.

Finally, these bills extend the minimum offering period during which a takeover must remain open, so a target company can provide can provide competent and adequate information to shareholders to insure sound business judgments.

NAWGA supports giving all parties the time and information needed for rationale, economic judgment. If a raider is truly acting in the best interests of a target company's stockholders, he should have no objection to facilitating an informed judgment by all parties.

Another corrective action that is possible is through the tax system. Presently the Federal Government is subsidizing hostile takeovers that may not be in the public interest. The raider company can deduct the interest on debt borrowed to finance hostile takeovers. They may also depreciate acquired assets from a higher stepped-up basis, a tax advantage denied the defendant target company.

We endorse the concepts embodies in H.R. 1003, and H.R. 1100, both introduced by Congressman Jones, and its companion bill, S. 476, introduced in the Senate.

Friendly mergers and acquisitions remain untouched by this legislation.

NAWGA supports legislation that would impose an excise tax on the recipient of greenmail, similar to the excise tax in the Tax Reform Act of 1984, on recipients of golden parachute payments.

We would also deny section 163 interest deduction for junk bonds, bank loans, or any other hostile-acquisition related indebtedness.

We would also support denying the hostile bidder a stepped up basis for depreciation and amortization, unless the step-up is recaptured and taxed. This would require amending sections 337 and 338 of the Internal Revenue Code.

This committee might also consider restrictions on pension funds, or other nonprofit institutional investors speculating in short-term takeover situations.

The impostion of a tax, waiveable upon some minimum holding period, would help relieve some of the pressures of short-term incentives and focus of money managers.

The Tax Code has played an unintended role in today's merger and acquisition environment. Business is spending billions of dollars to retool factories, to improve productity and to remain competitive in today's global marketplace.

We are making long-term investments to earn a share in the domestic and world markets, and to provide jobs. The current hostile takeover situation is seriously undermining these priorities. Corporate raiders focus on short-term performance, which is a reward for simple rearranging of assets, instead of creating new wealth and increased production.

The focus on the dismantling of productive assets not only distracts our economy, but dilutes our ability to compete internationally.

Thank you for this opportunity to express the views of NAWGA and the wholesale food industry. I would be happy to respond to any questions.

[The prepared statement follows:]

STATEMENT OF JACK TWYMAN, CHAIRMAN, CEO AND PRESIDENT, SUPER FOOD SERVICES, INC., ON BEHALF OF NATIONAL-AMERICAN WHOLESALE GROCERS' ASSOCIATION

Mr. Chairman, members of the committee, thank you for the opportunity of allowing NAWGA to present its views before you today on such an important topic as mergers and acquisitions.

I am Jack Twyman, chairman and CEO of Super Food Services, Inc. I am here today as a past chairman of NAWGA and as a current member of its executive committee. First, let me say a few words about Super Food Services and then about NAWGA.

Super Food Services, Inc., is one of the largest food wholesalers in the United States, employing over 1,800 people, and is primarily engaged in the wholesale food distribution business. Annual sales are approximately $1.3 billion. Super Foods holds Independent Grocers' Alliance Distributing Co. (IGA) franchises for each of its warehouse locations. Through our operating divisions and subsidiaries, we sell wholesale, food products, health and beauty aids, general merchandise, and other non-food items to 379 independently owned IGA retail food stores and 413 contract stores, which include other independently owned retail food stores in the states of Ohio, Michigan, Florida, Kentucky, and Indiana. In addition, Super Foods provides merchandising, advertising, sales promotion and administrative programs and counseling for these retail stores.

NAWGA is a nonprofit trade association of grocery distribution companies that provides programs in technical, educational, and government services on behalf of its nearly 400 wholesale grocers. NAWGA members operate over 700 distribution centers nationwide, serving thousands of independent grocery stores and foodservice establishments throughout the Nation. NAWGA members' annual sales volume approaches $50 billion, accounting for roughly one-third of the Nation's grocery supply distributed through such centers. In addition, NAWGA members employ approximately 250,000 people nationwide.

As this committee knows, since its inception, U.S. tax laws have been used for purposes of formulating economic policy as well as broad public policy matters. Without passing judgment on the merits or pitfalls of such an approach, let it suffice to say that our tax laws will continue to be used for encouraging or discouraging economic activities believed to be in the best interest of our country. Therefore, the fundamental question before us today, is whether mergers and acquisitions constitute a type of "economic" behavior that should be reconsidered in light of increased hostile takeover activity.

NAWGA members have been, and remain, ardent supporters of the free enterprise system. History has demonstrated that our economy is most productive when government interference is kept to a minimum. Consistent with this philosophy is a free market system that provides a forum for corporate mergers and acquisitions that result in appropriate allocations of capital resources.

Through friendly mergers and acquisitions, the wholesale food industry has emerged stronger and more competitive than ever. Many of our industry's recent acquisitions appear to have been made with specific goals in mind: controlling distribution costs, improving productivity, immediate access to constant technology changes, and territorial growth possible only through acquisition. The net effect has been to strengthen our Nation's independent grocers so they can compete affectively with the national chains.

An important point that should not be overlooked is that mergers and acquisitions in the wholesale food industry have been friendly and, in each instance, desirable resulting in a more viable and independent grocer.

The vast majority of NAWGA members are privately-held corporations. And, as in the case with many medium-sized growth companies, capital for expansion purposes can be difficult, if not impossible, to raise. Moreover, principal owners of these companies eventually find themselves with potential liquidity problems for estate tax planning. This becomes particularly acute, when family heirs have no interest in continuing the family-owned business.

Consolidation, through mergers and acquisitions, has helped our industry resolve many of these problems while improving economies of scale in physical distribution, maintaining food prices below prevailing inflation rates, and remaining the most

competitive industry in the United States, with after-tax profits of less than 1 percent.

NAWGA members embody the spirit and the dedication associated with the entrepreneurial spirit that has made this Nation great and, at the same time, providing the most efficient food distribution system in the world. The only thing that could jeopardize the goose that lays the golden egg is a continued proliferation of "hostile" takeover attempts. As in the case of most hostile takeovers, they are motivated by a small group of investors seeking short-term gains with little regard to long-term consequences.

Students of mergers and acquisitions usually fall within two schools of thought. The "Chicago School" contends that hostile takeovers are simply a preferred free-market mechanism in which society's resources are allocated to their most efficient use; in other words, corporate Darwinism.

The other school believes that hostile takeover attempts are abuses of the free market principle which are disruptive, short-term, profit-motivated actions of professional "speculators."

NAWGA firmly believes that the actual or potential harm caused by hostile takeovers, far outweighs any actual or theoretical benefits. We believe that unbridled hostile mergers and acquisitions will give rise to serious long-term social and economic consequences that will further reduce our ability to compete in today's global markets. As every CEO knows, there is no substitute for long-term strategic planning to ensure steady and lasting growth. This also means weathering economic slowdowns as well as taking advantage of periods of high product demand.

The food industry, like the oil industry, is critical to our nation's national security and well-being. Therefore, the abusive tactics used by corporate raiders must be examined in this context. Even the most staunch free-market player could not disagree with the proposition that the hostile takeover bidder now holds most of the cards.

Typically, a corporate raider, usually acting in secrecy, will acquire a small interest in a publicly-held corporation. The raider will then make a tender offer contingent upon financing. The tender offer is often coercive to the target's stockholders because it is usually of the "two-tier" variety. In such an offering, the offer is financed by participating "debt" issued by a "shell" company controlled by the raider. The shareholders are usually given a cash premium in the first tier of the offer and then, in the second tier, after the raider is in control, remaining shareholders will be forced to accept low-rated, often subordinated, high-risk, high-yielding "debt" obligations, now referred to as "junk bonds."

In order to protect their investment, shareholders are "coerced" into tendering on the first tier, or face the risk of being forced to accept low-rated debt that is generally worth less than the cash offered in the first tier.

Moreover, the shareholder and the target company are usually at a disadvantage because of the speed in which all this occurs. The raiders may spend months preparing for the hostile takeover. The target, on the other hand, has precious few weeks to prepare a defense that hopefully, will allow shareholders to make a rational decision.

The raiders, who will have financed their purchases with borrowed funds, usually have only one interest in mind–to ensure the company is taken over as quickly as possible, so they can walk away with their pre-calculated spread on their leveraged investments.

If the raider acquires the company, it is not unusual that all or part of the company is liquidated by selling assets in order to service the incurred debt. If the raider does not succeed in acquiring the target company, he usually can sell his shares back to the target company at a premium price. This type of corporate extortion is commonly referred to as "greenmail" and it is at the expense of all the other shareholders of the corporation. The raider may then report the greenmail premium for his tendered shares as a capital gain. It is virtually a no-lost situation for the raider.

Drexal Burnham Lambert, Inc., a leading proponent of junk bond financing, explained the process best in a recent Business Week (March 4, 1985, pg. 90):

"Drexel's 'leverage' takeover works like this: The buyer sets up a new company on paper. Drexel creates a package of junk bonds to be issued by the paper company once it gains control through a tender offer. Then Milken (Drexel's head of its joint securities trading department) and his 125-person staff contact junk-bond investors, seeking advance commitments to buy the bonds. Once in control, the raider can raise cash by selling off pieces of his new property. 'We take a minnow, identify a whale, then look to its assets to finance the transaction', explains Michael D. Brown, Drexel's west coast merger chief."

Can anyone on this committee today, tell me that this is good public policy? This is the "preferred" strategy of today's corporate raiders because gains are sheltered by the high leveraged junk bond expense. At the same time, these write-offs are not available to a company interested in continuing for the long-term.

Unlike friendly acquisitions, hostile takeovers are a blatant misuse of capital. Takeover attempts and target defenses can cripple the surviving company by burdening it with enormous debt. This nonproductive debt, which is being used to retire equity, can seriously jeopardize the financial soundness of an otherwise sound business.

These raiders are good at is "greenmail" or "liquidation." It is important to reiterate to this committee that we are not advocating that mergers and acquisitions be restricted–only hostile takeovers, which usually serves no one's best interest other than a small group of sophisticated investors.

What can be done? First, although not in the jurisdiction of this committee, is to amend the Williams Act whose ideal of a "level playing field" between bidder and target has run amuck.

Several bills now pending before the House and the Senate, while they differ in their approach, do share a common objective: To ensure that an informed and deliberate decision can be made by individuals conversant with the short and long-range implications of a particular takeover proposal.

Thus, each of these bills:

(1) Provides for increased disclosure as to the bidders' goals and business plans with respect to the target, and with the anticipated effects of such actions on the bidder, the target, shareholders, employees, creditors, suppliers, customers and the community in which it operates.

(2) Puts into place an approval process whereby outside directors and/or shareholders of both the bidder and the target companies would approve any particular takeover before it could be consummated, and

(3) Extends the minimum offering period during which a takeover offer must remain open, so that a target company can provide competent and adequate information to shareholders to ensure sound business reason.

NAWGA supports this type of approach that encourages rational economic judgment while removing the coercive and destructive tactics that are employed in today's hostile takeover environment. If a raider is truly acting in a target company's best interest, it should have no objection to allowing all parties concerned to make an informed decision.

Another aspect impacting on mergers and acquisitions is the tax system itself. Presently, the Federal Government, through all taxpayers, is subsidizing hostile takeovers that clearly are not in the best public interest. In effect, Treasury is a silent partner with these speculators. Our tax system rewards raider companies by permitting the interest on debt borrowed to finance hostile takeovers to be deducted and by allowing acquired assets to be depreciated from a higher stepped-up basis–a tax advantage the target-defender is not entitled.

For these reasons, we endorse the concepts embodied in H.R. 1003 and H.R. 1100, both introduced by Congressman Jones and its companion bill, s.476, introduced in the Senate. We are convinced that the provisions found in the above-mentioned bills in no way compromises or impinges upon the free-market principles that has made this country the wealthiest in the world.

Through a group of sophisticated speculators, enormous amounts of capital are being raised through the use of high risk "junk bonds" for their own short-term gain at the expense of long-term performance of financially sound and profitable companies. Although limited in scope, the Jones bills specifically addresses problems created by hostile takeovers. Friendly mergers and acquisitions would remain untouched by this legislation. NAWGA firmly supports legislation that would:

Impose an excise tax on the receipt of "greenmail" similar to the excise tax passed in the Tax Reform Act of 1984 on recipients of golden parachute payments.

Deny the section 163 interest deduction with respect to "junk bonds" as well as bank loans or any other hostile-acquisition related indebtedness.

Deny the hostile bidder company from stepping-up the basis of a target corporations assets for purposes of depreciation and amortization unless the step-up is recaptured and taxed. This would require amending sections 337-338 of the Internal Revenue Code. Requiring a mandatory section 338 election and denying the availability of section 337 treatment for liquidations in a hostile acquisition, would bring legislative "neutrality" between the bidder and target.

Last, but not least, this committee might consider imposing certain restrictions on pension fund or other "non-profit" institutional investors who now dominate the markets. The imposition of a tax, waivable upon some minimum holding period,

would help relieve some of the pressures of short-term incentives and focus of money managers. Speculation by institutional money managers has had the unintended effect of fueling the fire that is out of control in the hostile merger and acquisition markets.

Mr. Chairman, the thrust of my testimony today has been to point out the unintended role the Tax Code has played in today's merger-acquisition environment. For the past several years, business has been spending billions of dollars to retool its factories, to improve productivity, and to remain competitive in today's global marketplace. We are meeting this challenge. We are making the necessary long-term investments that will ensure our dominant position in the world markets, while providing needed jobs at home. However, the current hostile takeover environment is seriously undermining these important national goals and priorities. Corporate raiders place too great a focus on short-term performance which rewards simple rearranging of assets and not the creation of new wealth, shifts our attention from increased production and development to the dismantling of productive assets, and most importantly, dilutes our ability to come face-to-face with international competition. These concerns should be of paramount importance in setting our national priorities. Thank you for this opportunity to express the views of NAWGA and the wholesale food industry. I would be happy to respond to any questions you might have.

Mr. FLIPPO. Thank you very much.

Would you like to proceed with your testimony?

STATEMENT OF ROBERT F. HARBRANT, PRESIDENT, FOOD & ALLIED SERVICE TRADES DEPARTMENT, AFL-CIO

Mr. HARBRANT. I am Robert Harbrant, and I am president of the Food and Allied Service Trades Department of the AFL–CIO, which is commonly known as FAST. FAST has 15 affiliated unions representing some 3.5 million workers throughout the country.

I want to thank you for the opportunity to appear before you today to present some of our views on the impact of the Tax Code on mergers and acquisitions. Before doing so, you should understand that the leadership of the AFL–CIO and some of its affiliates will be presenting wider ranging testimony to other congressional committees on the current wave of hostile takeovers capturing the attention of the Nation.

I think it is necessary though for me to make a few general statements which will allow you to place my specific comments in their proper context. First, we do not advocate outlawing takeovers. Rather, we are urging the Congress to pass laws affecting them in ways which good public policy demands. Second, we are not interested particularly in protecting incumbent management. In this regard, we may share raiders' antipathy toward incompetents, albeit for different reasons.

Earlier this month, you heard from a number of corporate executives, investment bankers, and lawyers. The raiders all railed against even thinking about changing the Tax Code. It, they argue, must remain neutral. If you fail to maintain the status quo, you will, in the words of some, upset the delicate balance whiih now exists. Others cloaked themselves in that tried and true test of patriotism, the free market.

The target company executives all urged the most stringent measures to inhibit the ability of takeover artists to stalk their prey. Some of these gentlemen were quick to appear as champions of employees and the community.

To say I am uncomfortable reading the testimony of both sides is polite understatement. Knowing the Congress, I am confident you will separate truth from fiction and take appropriate action.

Like most of the others who testified, I am not a tax expert, but I do think we can assist you in defining the problem and searching for the right path.

The Tax Code is not now, nor ever has it been, truly neutral. The raiders want no change because the current code helps them in a myriad of ways to select their target, raise the capital to overwhelm it, and maximize their profit by sheltering much of it.

The most important question is whether the current wave of takeovers is in the interests of the American economy. If so, leave the Tax Code alone. If not, then adjust it to reduce the number, size, and type of takeovers which represent the greatest danger. We share the opinion of many that most of the takeovers occurring of late are harmful, not only to the hundreds of thousands of working people, but to the fabric of the economy as well.

While changing the Tax Code is only a partial answer, it is a necessary beginning. Changing the securities laws is also necessary, but tax action will have the kind of effect businessmen understand—it will either raise or lower the final cost of the deal.

By increasing the cost of takeovers, you will certainly reduce their number, and not incidently encourage the channeling of capital into more productive uses.

Clearly, the role of debt is crucial to the dynamic of takeovers in all their forms. The figures reported to this committee on how much debt has been created in pursuing and defending against takeovers is truly frightening. To believe the Tax Code should encourage corporate debt formation as opposed to corporate capital formation is sheer nonsense, and that is what those who advocate maintaining the status quo are in effect arguing.

We have seen too often how corporate management relieves its debt burdens. The Disney case is a good example. Soon after paying over $300 million to a group of highwaymen posing as free market entrepreneurs, Disney management tried to recoup some of the cost from its employees. For the first time in over 25 years of a collective bargaining relationship, these employees at Disneyland went out on strike. Their resolve beat back the worst of the concessions sought by management. Suffice it to say, workers have learned many bitter lessons of late about the meaning of corporate debt formation.

Another area of concern is net operating loss carryovers. Do they act as magnets for raiders? If we had any doubt NOL's were crucial to target selection by raiders, a recent experience eliminated all doubt. Beginning in late November, FAST assisted Pantry Pride, a Florida-based retailer, resist a hostile takeover. The raiders in this case thought they could accomplish their goal on the cheap—by winning a proxy contest.

The raiders, led by Rooney Pace, an investment banking company, with grandiose plans but without commensurate abilities, were attracted by Pantry Pride's remaining $315 million NOL.

Pantry Pride is the new company which emerged from the bankruptcy of Food Fair. It had settled with its creditors, and reorganized itself with the cooperation of its employees and their union,

the United Food and Commercial Workers, in Florida. The workers had made numerous sacrifices in this effort. Now a group of opportunists were trying to take control and liquidate most of the company's supermarket business. They came close to winning. Our interest in helping the company resist the takeover was to protect the jobs of over 4,500 people.

The victory simply bought time. A few months later, someone else came knocking at the door. Having spent nearly $3.4 million fighting off the first attack, company officials were hesitant to do so again. One can argue with this decision, but the fact remained that winning again would not necessarily deter a third group from trying to take control. So the company negotiated a "friendly" deal. Fortunately, the local union was in a position to negctiate a new contract which protects its members' job security should the supermarkets be sold. The Tax Code unintentionally but unmistakably made the company a target.

We think the definitions of substantial control and many of the mechanics of using NOL's contained within the Tax Code should be reviewed closely and changed so viable companies having returned to financial health do not fall prey to opportunists. In our view, losing the tax advantage in these circumstances would discourage such takeovers.

While some raiders may not be motivated by the Tax Code in their search for oil on Wall Street, many other raiders are. Few will admit it, for to do so would invite the kinds of changes the Congress is contemplating and we are encouraging.

If the committee were to request and receive copies of the tax opinions written for the raiders and their bankers in previous efforts, you could resolve, once and for all, the role the Tax Code played in particular contests. Since these contests for control are now history, turning them over to the committee staff would not compromise any of the raiders' current efforts. It would be interesting to see what kind of cooperation you received. Either way, the committee would have the answers it needs but does not seem to be getting in testimony.

Mr. Chairman, we view this whole scenario of corporate mugging as having profound impact on our financial system and our American way of life. The stress placed on these corporations, the workers, and the entire economy bringing more than a bevy of new words to the Wall Street Webster. Along with raiders and shark repellents and greenmailers and white knights and junk bonds and poison pills, it is creating massive insecurity, confusion, loss of jobs, unsettled communities, and havoc of unknown heights.

The hostility and unpredictability is busting up and liquidating businesses and spouting unprecedented misery on whole industries, entire cities, as well as working families.

Mr. Chairman, we think that the workers deserve a role in this total consideration, and we thank you for the opportunity of presenting our views, and we will attempt to assist the committee in any way we can.

Thank you.

Mr. FLIPPO. Thank you very much for your testimony.

Mr. Schuchert has arranged for more than 600 ESOP's since 1970, so you have a lot of experience in that area.

Mr. SCHUCHERT. That's correct, sir.

Mr. FLIPPO. The Tax Code changes in 1984 seems to have spurred—I'm sorry—in 1982 seems to have spurred the use of ESOP's.

Mr. SCHUCHERT. Do you mean in 1984? I think you mean the recent changes last year?

Mr. FLIPPO. Yes.

Mr. SCHUCHERT. In the Deficit Reduction Act?

Mr. FLIPPO. Yes.

Mr. SCHUCHERT. I think that is the supposition made in a recent Business Week article. However, our own experience has indicated that although there has been a lot of conversation about the provisions of the 1984 act and the growth of ESOP's, the growth of ESOP's since the available data on this matter indicates that ESOP growth has been well underway through the 1970's and through the early 1980's.

With regard to the specific provisions of the act, except for one case, the recent transactions which we have been involved with, did not access or benefit by any of the provisions of the 1984 act. Now, we hope in the future to benefit from those provisions.

Mr. FLIPPO. Are you currently marketing ESOP's to firms? Are you identifying targets that are potential clients of yours?

Mr. SCHUCHERT. No, that is not the normal way in which we promote our business objectives. We started way back as a firm in 1969 and most of the transactions we did over the years were private companies and smaller public companies.

Most of our clients were a result of our talking to these companies about including employees in the ownership of the business and building capital with the benefits the ESOP offered. It's only been since 1982 that we have been approached, only on a couple of occasions, by firms who have been in a position where they are attacked by "corporate raiders," with their backs against the wall, so to speak.

And our view of those transactions is that it is much better for the employees to own that business than for a raider to own the business.

Mr. FLIPPO. Well, is it your thought that the Dan River situation worked to the best interest of the workers in that sense?

Mr. SCHUCHERT. Oh, absolutely. Absolutely.

Mr. FLIPPO. That is an interesting case, because I believe management paid something like $4.3 million for 30 percent of Dan River and the workers paid $110 million for 70 percent. That sort of looks like——

Mr. SCHUCHERT. If that were the case, it would be an outrageous inequity. But that is not the case.

Mr. FLIPPO. So those figures are in error?

Mr. SCHUCHERT. They are in error as to the way the value of company stock is depicted. For example, Dan River workers have a guaranteed buy-back price for their stock at $22.50 per share, which has been funded. If the stock increases in value, it can be redeemed at the higher level. There is no similar guarantees for the management stock. Also, the employee stock was acquired with a nonrecourse note to be retired by future contributions of the company. By contrast, management stock was purchased with cash

from managers themselves. Further, employees stock has a dividend and liquidation preference. It is a senior security, much more valuable than other classes of stocks.

In fact, today the management's stock is worth a negative $18 per share.

Mr. FLIPPO. Well, in other words, you are saying that management did not pay $4.3 for 30 percent or $110——

Mr. SCHUCHERT. No, sir, they did not.

Mr. FLIPPO. The workers now have the risk of ownership, I believe. Do they also have all the other attributes of ownership? Can they vote, for instance, to elect board members?

Mr. SCHUCHERT. Under current law, because Dan River is a private company. No, they cannot vote to elect board members. They can vote on those corporate matters, which, by law or character, must be decided by more than a majority vote of shareholders. For example, on a tender offer. Workers in a public company with a leveraged ESOP with publicly traded stock may direct the manner in which their stock is to be voted on all matters.

Mr. FLIPPO. Who votes their stock?

Mr. SCHUCHERT. Their stock is voted by an ESOP fiduciary committee appointed by their board of directors.

Mr. FLIPPO. A trustee, but they can't vote for their board of directors?

Mr. SCHUCHERT. Not under present law.

Mr. FLIPPO. So, while they have all the risks, they do not have all the voting authority of stockholders then?

Mr. SCHUCHERT. Well, it depends upon what you look at as risks. You must remember that they can vote on all other corporate matters which require a majority vote of the shareholders. Also, ESOP shares are purchased with a nonrecourse note at no out-of-pocket cost to the employees. The issue of vote passthrough is one that Congress has addressed before. Although Kelso & Co. is in favor of the passthrough of voting rights on all matters, presently the law does not mandate it.

There are many factors to consider. For example, from a business point of view, banks and other lenders who are loaning hundreds of millions of dollars for an acquisition transaction insist upon the assurance of ongoing stability of management whether or not ESOP is involved. If this group of gentlemen here on the witness panel and I together did a non-ESOP leverage buy-out, we would not have the freedom to vote our shares to change management until the banks had most of their debt paid off.

Mr. FLIPPO. Well, that Dan River operation is something that raises a lot of serious questions. I wish I had more time to go into it, but I'll yield to my colleagues at this time. Thank you.

Mr. SCHULZE. I was not aware that there had been mergers or acquisitions in the wholesale grocery area. Have there been takeovers?

Mr. PECK. There have been takeover attempts, partial takeovers, but they are small in number and are relatively new. There have been a great many mergers and acquisitions that we would refer to as friendly, as sought by both parties. I would say that the typical situation in our industry is for the smaller company, who has problems today operating, because the economy scale has overwhelmed

them to seek a buyer, and it works well for them because they continue in business, same management, same people, but they have access to capital that was not available to them previously and access to technology they couldn't handle previously. So they are common.

Mr. SCHULZE. Do you really believe that the Tax Code is the place to cure this problem that we have been discussing?

Mr. PECK. I'm not competent to respond to that. It would appear to us that since——

Mr. SCHULZE. Let me say if there is some correction to be made, it seems to me the last place to which we should resort is the Tax Code. Unless we view all mergers as equal, we are going to have to determine what is a friendly merger and what is a hostile takeover. At best we can draw guidelines and at worst, the corporations can change the makeup of their boards and do whatever they would like, unless we then dictate the makeup of the board.

It seems to me that this is not the forum to stop these kinds of activities, if they really are as bad as some people say they are. You say there have been a fair number of mergers and acquisitions in the wholesale grocery business?

Mr. PECK. Yes.

Mr. SCHULZE. Have these been vertically integrated?

Mr. PECK. No.

Mr. SCHULZE. Does the retailer get into the wholesale business at all or is that a separate level?

Mr. PECK. Very rare. It has happened that wholesalers have purchased their retail customers and converted into a chain, but then they are no longer considered to be a wholesaler and that is very rare.

Mr. SCHULZE. Any reason for that lack of vertical integration?

Mr. PECK. Probably because the wholesaler of today's food industry has found a niche where they perform an economic function more efficiently. We have found that, for example, 25 percent of the purchases made by chains who could operate their own distribution centers are funneled through wholesalers for two reasons. One, they find the wholesalers to be more efficient, and the other is that it frees their own capital for expansion on the retail side, which is more profitable.

Mr. SCHULZE. Historically the profits in retail grocery sales are extremely low, somewhere between three-quarters of 1 percent and maybe to a high of 1½ percent; isn't that correct?

Mr. PECK. That's correct.

Mr. SCHULZE. What are the profit structures in the wholesale grocery business?

Mr. PECK. The wholesalers net after tax is under 1 percent, half to three-quarters.

Mr. SCHULZE. It is somewhat comparable then to the——

Mr. PECK. There is a distinction. We are speaking of wholesalers who sell to supermarkets or retail grocery stores. We also serve in our association wholesalers who sell to hotels, restaurants, schools, and other institutions. They have a different structure. It is a different type of business and they enjoy a higher after-tax profit on generally much lower volumes.

Mr. SCHULZE. If you had to select two items in the Tax Code which have encouraged hostile takeovers, which two would be most influential?

Mr. PECK. Well, I would make a personal judgment to respond to your question, sir, that the opportunity to write up the depreciation would be one and the deductibility of the interest on the debt that was incurred specifically to make the takeover.

Mr. SCHULZE. Thank you, Mr. Chairman.

Mr. FLIPPO. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Schuchert, was Kelso & Co. also involved in Ramen International?

Mr. SCHUCHERT. Yes, sir, we were.

Mr. ANTHONY. I notice in your testimony that you would be glad to work with committee members and with the staff in better understanding Dan River. Could you make the same offer on Ramen International?

Mr. SCHUCHERT. We surely will.

Mr. ANTHONY. I think it is important in the light of the Business Week article and in light of Mr. Flippo's questions. I must admit I had a few questions after I read the Business Week article.

Presently, I would like to ask a couple of basic questions. Later I will probably be working with the staff to submit other questions to you or work out another meeting where we can really get together and go through it in great detail, but——

Mr. SCHUCHERT. We'd be happy to do that.

Mr. ANTHONY. On page 5 of your testimony, you state that the primary purpose of the ESOP is to serve as an incentive for corporations to structure their employee benefit and financing plans so that workers can have an equity ownership rather than as a retirement or any other financing vehicle.

Mr. SCHUCHERT. That's right.

Mr. ANTHONY. But if you look at Dan River, employees did vote to replace their pension plan with an ESOP and then employment did go from 12,000 to 8,000.

Mr. SCHUCHERT. That's correct.

Mr. ANTHONY. The question that immediately comes to mind is what happened to those 4,000 people that were laid off? Were they protected in any way?

Mr. SCHUCHERT. The 4,000 people who were laid off got the full value of their ESOP account paid to them in cash at the time they were terminated, if they were permanently terminated. As stated earlier, the workers at Dan River have a guaranteed buy-back floor price of $22.50 per share for their stock.

If it was a short-term layoff, there was no distribution or termination made of their ESOP participation, probably because they anticipate being recalled to work within a 6-month period. So there is a guaranteed buy-back from each employee at the time he terminates at the original acquisition price of $22.50 or the current market price for that stock, whichever is higher.

Mr. ANTHONY. So at first blush, in reading an article that doesn't go into all of the details, if one could go in with the preconceived idea to slant the viewpoint, could one make it look like an ESOP vehicle was used for the wrong purpose in the Dan River case?

Mr. SCHUCHERT. It seems that way in light of the fact that we gave Business Week over 20 companies of about similar size that have had ESOP plans in for years and suggested that they go to those companies. It was somewhat surprising that they didn't cite any examples from other enterprises.

Mr. ANTHONY. For the record today, could you just quickly give us a thumbnail sketch of why, when you made the analysis of Dan River, an ESOP made sense and why Dan River would be in a better situation afterwards as opposed to letting some outside investor like Ichan come in and take them over?

Mr. SCHUCHERT. Well, there are both economic and obviously social factors involved here. When we were called into Dan River in Danville, the citizens in the town were literally having prayer meetings once a week in both synagogues and churches to come up with a way to defeat a tender offer by Carl Ichan.

In Mr. Ichan's 13-D notice of filing with the Securities Exchange Commission, he said one of his alternatives was possible liquidation of the enterprise. Danville is strictly a Dan River town. Textiles is about the only industry in the town. Therefore, it was not only the management of that enterprise, but all of the employees, the suppliers, the community, the churches, and everyone else who was interested in trying to maintain Dan River as an independent company.

We looked at the transaction. We knew that other firms had looked at it from a standpoint of doing a conventional leverage buyout or a merger type of transaction. The merger transactions which were proposed all involved a substantial modification of the facilities and a substantial closing down of many of the Dan River facilities and probably a major loss of permanent employment in that town.

The ESOP offered us an opportunity to do several things in a single transaction. No. 1, to finance the acquisition debt using pretax dollars from the ongoing revenues of the business.

Second, it offered us a way to keep the ownership substantially within the employees, without the necessity of bringing in major outside investors who would demand a large piece of the equity. The use of the ESOP financing techniques, which are attributable, obviously, to the provisions of the Tax Code in allowing the deduction of payments to the ESOP, allowed us to structure a transaction under which Dan River, despite the fact that it is in a tough industry, will pay off its debt in 5 years. At present, more than 50 percent of its debt has already been paid off.

It is on schedule or ahead of schedule on the payoff. The company is slightly profitable right now, and its problem is not the ESOP, but foreign textile imports, which have just devastated its markets. The company as far as I am able to determine has taken no action that wouldn't have had to be taken had the company remained a public enterprise or had no ESOP.

In other words it wasn't because of the ESOP or interest and principal payments in the leveraged acquisition that employees were laid off. Employees were laid off because there was no market for products and inventories were piled up. So that what we did there is maintained a situation where more than 10,000 employees of the permanent base will own not 70 percent, but more like 88

percent of the total value of that enterprise without paying anything for it; where if it works well, the average employee should have in a period of 9 to 10 years something like $60,000 to $70,000 in his account, with the assurance of converting it to cash.

It seems to me this is a better alternative than Carl Ichan taking control of the business.

Mr. ANTHONY. Mr. Chairman, my time has expired, but I think it is important to get one last question in, with your permission.

Mr. FLIPPO. Yes, sir.

Mr. ANTHONY. Do you see an increase because of the 1984 Tax Code changes in leverage buyouts?

Mr. SCHUCHERT. No; in leverage buyouts in general? No, sir; most people do not want or most of the investment banks are not interested in the kind of leverage buyouts that we do.

Mr. ANTHONY. So, if you see any change at all, it will be the intended result to spread the equity base to the employees?

Mr. SCHUCHERT. It offers opportunities for those people who are willing to share ownership. The ESOP is not merely something that you use as a financial device without paying for it. When you use it, you allocate a major part of the equity to the employees and most of the bigtime investors and even investment banks are not interested in that alternative.

Mr. ANTHONY. Thank you very much.

Mr. Chairman, I think we ought to take the opportunity that has been offered us to take a close look at both of these circumstances to make sure that the record is very complete, because I know that I had many questions pop into my mind as a result of reading that Business Week article. I thank you for offering the opportunity to do that.

Mr. FLIPPO. I did have one—Mr. Schuchert, since this committee is trying to determine what role the Tax Code plays in these particular contests and since your company is very active in counseling people on how to structure and finance these type of operations, surely your company has had access to copies of tax opinions that are written for people interested in taking over these operations since 1970. I wonder if you might share some of those tax opinions with the committee at some time, so that we might really see what role the Tax Code has played.

Mr. SCHUCHERT. I'd be happy to do that. I can very briefly comment that the most liberal changes in the tax laws with respect to ESOP's occurred in 1984. What has become now famous is the exclusion of 50 percent of interest from an ESOP loan.

That is that banks that loan in certain qualified ESOP transactions can exclude 50 percent of the interest income from taxation.

Mr. FLIPPO. Yes; if you could share those tax opinions, it would be very helpful.

Mr. SCHUCHERT. I'd be happy to.

Mr. FLIPPO. And Mr. Harbrant, you are totally satisfied with the definition of hostile takeover or would you be able to offer us some suggestions as to how we might have a better definition?

Mr. HARBRANT. Well, Mr. Chairman, I think it is very difficult to lay precise guidelines down for a hostile takeover. I think it depends as usual which side you are on. I think it is a situation that we are concerned about where the workers have no voice, no vote,

no protection, no parachutes, if you will, and I think in those cases there are abuses that are currently in the marketplace that need to be addressed by the committee.

Mr. FLIPPO. Thank you very much. Thank you for your testimony.

Chairman PICKLE. That will complete the testimony from this panel. We thank each of you for your testimony.

[The following was subsequently received:]

COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC, May 22, 1985.

MESSRS. SCHUCHERT, PECK, AND HARBRANT: Thank you for appearing as a witness at the Subcommittee's hearing on mergers and acquisitions. Your experience and expertise provided the Subcommittee with much valuable analysis and information. For the purpose of completing the Subcommittee's hearing record, I have enclosed a series of additional questions for your response.

I would appreciate your review and response to my office by June 3, 1985. If you have any questions, please contact Bill Cunningham of the Subcommittee staff at 225–5522.

Sincerely yours,

J.J. PICKLE,
Chairman, Subcommittee on Oversight.

Enclosure.

1. According to Business Week (April 15, 1985), Kelso & Company has arranged financing for more than 600 Employee Stock Ownership Plan (ESOP) leveraged buyouts since 1970. Do you ever promote ESOPs as a defensive tactic for corporate management attempting to fight off a takeover?

2. To the extent ESOPs are being used for defensive management purposes –

(a). It is due to the additional tax incentives in the 1984 Tax Act (such as the exclusion of 50 percent of interest income to lenders and the deferral of capital gain recognition)?

(b) It is due to the publicity accorded certain large leveraged buyouts such as the Phillips Petroleum battle where management proposed an ESOP to fend off a takeover attempt by T. Boone Pickens?

3.(a) To what kinds of companies do you market ESOPs?

(b) Have you targeted "target" companies as your potential clients? If so, what information do you use and what characteristics of a company are important?

4. It has been reported that in the Dan River leveraged buyout which you designed the employees voted to replace their pension plan with an ESOP in the face of the perceived threat of a takeover by Carl Icahn. Further, since going private, management has refused to disclose earnings, sales figures and stock valuation numbers to employees. Employees are allowed to vote only on the merger or the sale of the company and employment has shrunk from 12,000 to 8,000.

(a) Is this correct?

(b) Was the Dan River ESOP leveraged buyout a good thing for employees? For the company?

5. We also understand that the Kelso & Company put together the ESOP leveraged buyout of Raymond International, Inc. at a total cost of $219 million. As a result of that buyout, the pension plan was terminated, the management of the company bought 20 percent of the company for a nominal amount compared to the ESOPs input of $100 million, and since the buyout, the company's revenues have fallen from $1.6 billion to $1 billion and almost half of the employees covered by the ESOP have been laid off.

(a) Is this correct?

(b) Did this ESOP leveraged buyout work to the advantage of management and the disadvantage of employees of the company?

(c) Was what happened in this situation contrary to the policy underlying the tax incentives accorded ESOPs?

CORMAN LAW OFFICES,
Washington, DC, May 31, 1985.

Hon. J.J. PICKLE,
Chairman, Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: You will recall that our clients Kelso & Company presented testimony during the Subcommittee's recent hearings on mergers and acquisitions. During the hearing the company was asked to supply certain additional information for the record. The requested information entitled "Review of the Use of ESOP's in Selected Buyouts" is enclosed.

As you may recall, Kelso & Company is an investment banking firm specializing in leveraged acquisitions using employee stock ownership plan (ESOP) financing. Two other documents are enclosed on this matter for the Subcommittee's review. The document entitled "Return to An ESOP In a Leveraged Buyout" graphically illustrates the advantages of ESOP financing in comparison to non-ESOP leveraged financing—debt can be retired more rapidly and with less risk. There is also a high rate of return for employee stock with an ESOP. In a traditional buyout employees receive no ownership interest. The document entitled "Response to Business Week Cover Story" is an analysis of a recent Business Week story on ESOPs.

On behalf of Kelso & Company, I hope this information is helpful.

Sincerely,

WILLIAM A. KIRK.

Enclosures.

REVIEW OF THE USE OF ESOPS IN SELECTED LEVERAGED BUYOUTS

Introduction

The presentation is intended to provide information concerning the use of Employee Stock Ownership Plans ("ESOPS") in leveraged buyout transactions. Included in the presentation is a hypothetical transaction, which shows the effects of structuring the transaction utilizing No ESOP, an Unleveraged ESOP, a Leveraged ESOP, and a Leveraged ESOP which purchases 100% of the Company. Also included in the presentation is a review of four recent transactions which were structured by Kelso & Company. These transactions were chosen because they were all leveraged buyouts of public companies for which information was already publicly available.

HYPOTHETICAL TRANSACTION

Sources and Uses of Financing

Uses:	
Purchase stock	$100,000
Refinance existing debt	-0-
Closing costs	4,500
Total	$104,500

Sources:	
Existing cash	$ -0-
Interest bearing debt	94,500
Common equity	10,000
Total	$104,500

ASSUMPTIONS FOR HYPOTHETICAL TRANSACTION

Transaction

Purchase Price	$100 million
Founder's Equity Investment	$10 million
Total Acquisition Debt	$94.5 million
Transaction Costs	$4.5 million
Interest Rate on Debt	$13.0%

Company

Net Sales	$180 million, increasing 5% per annum
Operating Profit Margin	13.9% through projection period
ESOP Contribution	$10 million, growing at 5% per annum
Income Tax Rate	46%
Capital Expenditures	$6.0 million per year
Depreciation	$6.0 million per year

HYPOTHETICAL SCENARIO ANALYSIS

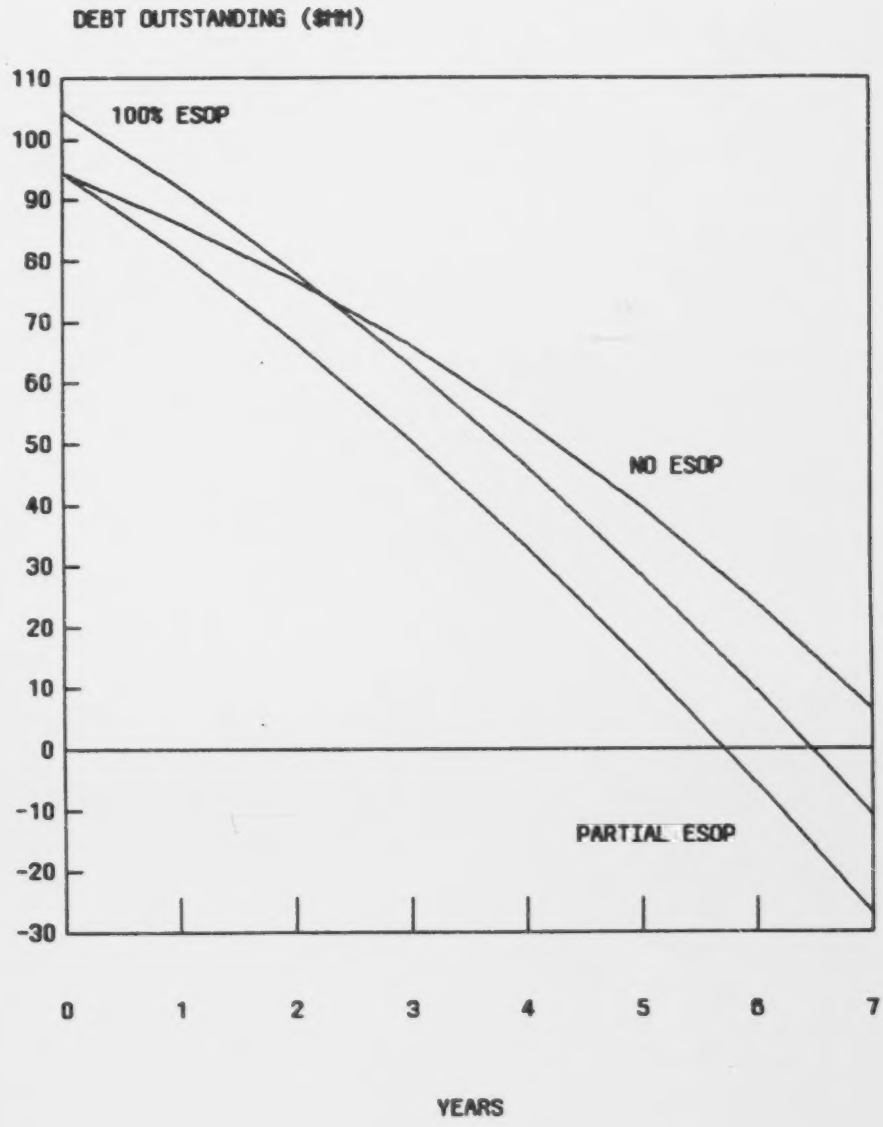
(000's)

NO ESOP	Closing	5th Year	7th Year
Debt	$94,500	$39,750	$ 6,461
Equity	10,000	57,237	93,835
Common Stock Price	$10.00	$113.93	$162.44
Rate of Return	—	62.7%	48.9%
Total Common Value	$10,000	$113,934	$162,442
ESOP Value	-0-	-0-	-0-
ESOP Ownership %	-0-	-0-	-0-
UNLEVERAGED ESOP	**Closing**	**5th Year**	**7th Year**
Debt	$94,500	$14,454	($ 27,136)
Equity	10,000	89,150	131,674
Common Stock Price	$10.00	$68.12	$88.18
Rate of Return	—	46.8%	36.5%
Total Common Value	$10,000	$132,607	$188,685
ESOP Value	-0-	64,510	100,525
ESOP Ownership %	-0-	48.6%	53.3%
Rate of Return	—	15.1%	14.5%
LEVERAGED ESOP	**Closing**	**5th Year**	**7th Year**
Debt	$94,500	$14,454	($ 27,136)
Equity	10,000	89,150	131,674
Common Stock			
-Class A	$100.00	$169.34	$225.41
-Class B	$21.40	$90.74	$146.81
Rate of Return			
-Class A	—	31.9%	20.0%
-Class B	—	33.5%	31.7%
Total Common Value	$10,000	$132,607	$188,685
ESOP Value	-0-	$90,207	$120,076
ESOP Ownership %	63.2%	63.2%	63.2%

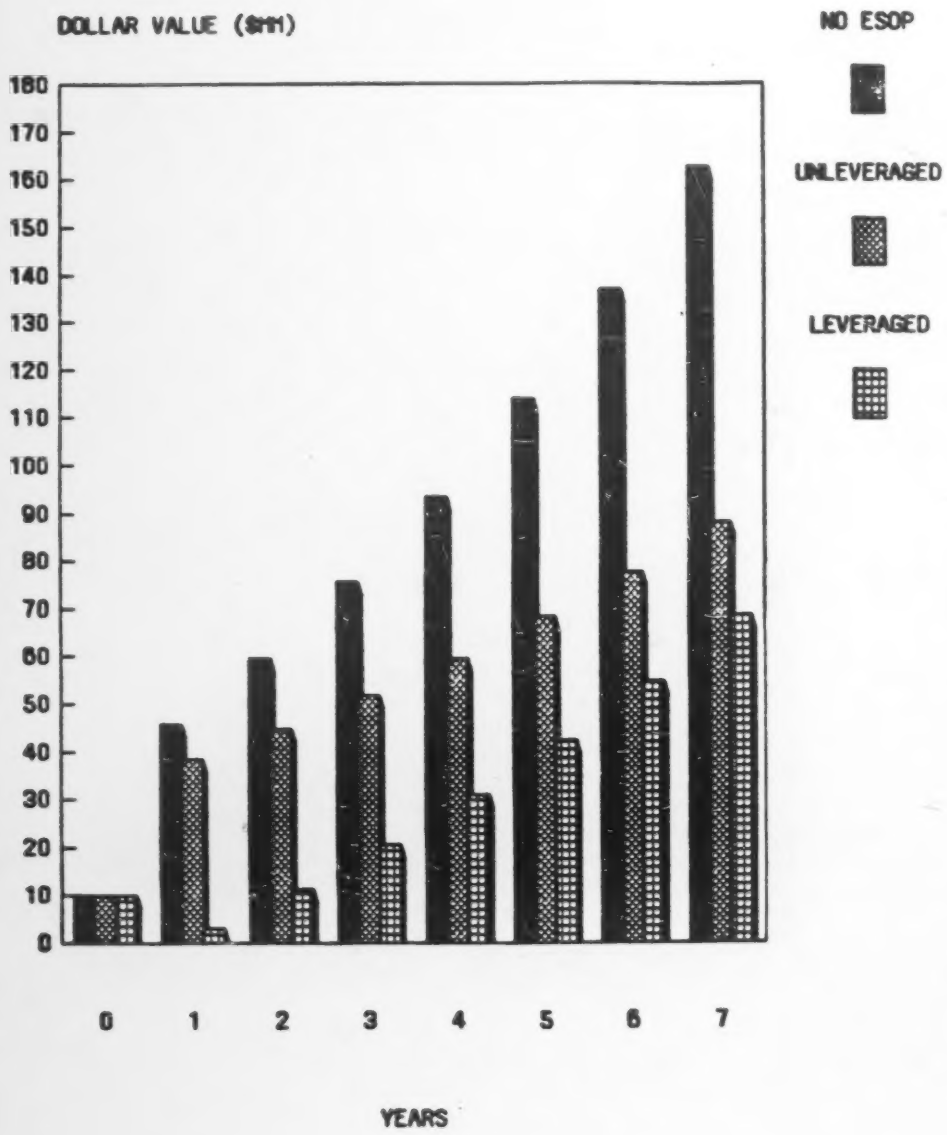
100% LEVERAGED ESOP	Closing	5th Year	7th Year
Debt	$104,500	$28,661	(10,787)
Equity	-0-	74,943	115,325
Common Stock Price	$___	$___	$___
Rate of Return	—	—	—
Total Common Value	-0-	$121,890	$175,799
ESOP Value	-0-	$69,190	$139,001
ESOP Ownership %	100%	100%	100%
Rate of Return	-0-	18.6%	24.6%

DEBT OUTSTANDING

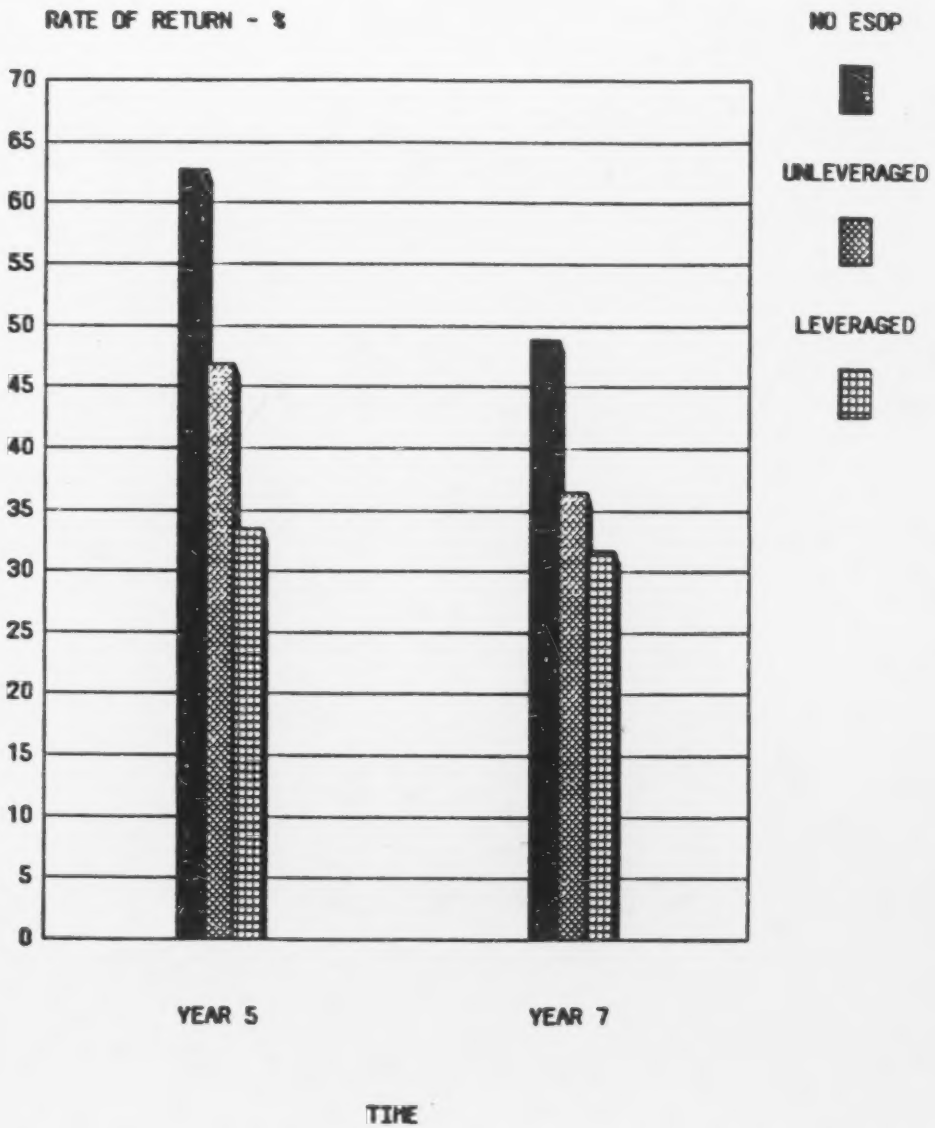
NO ESOP VS. WITH ESOP



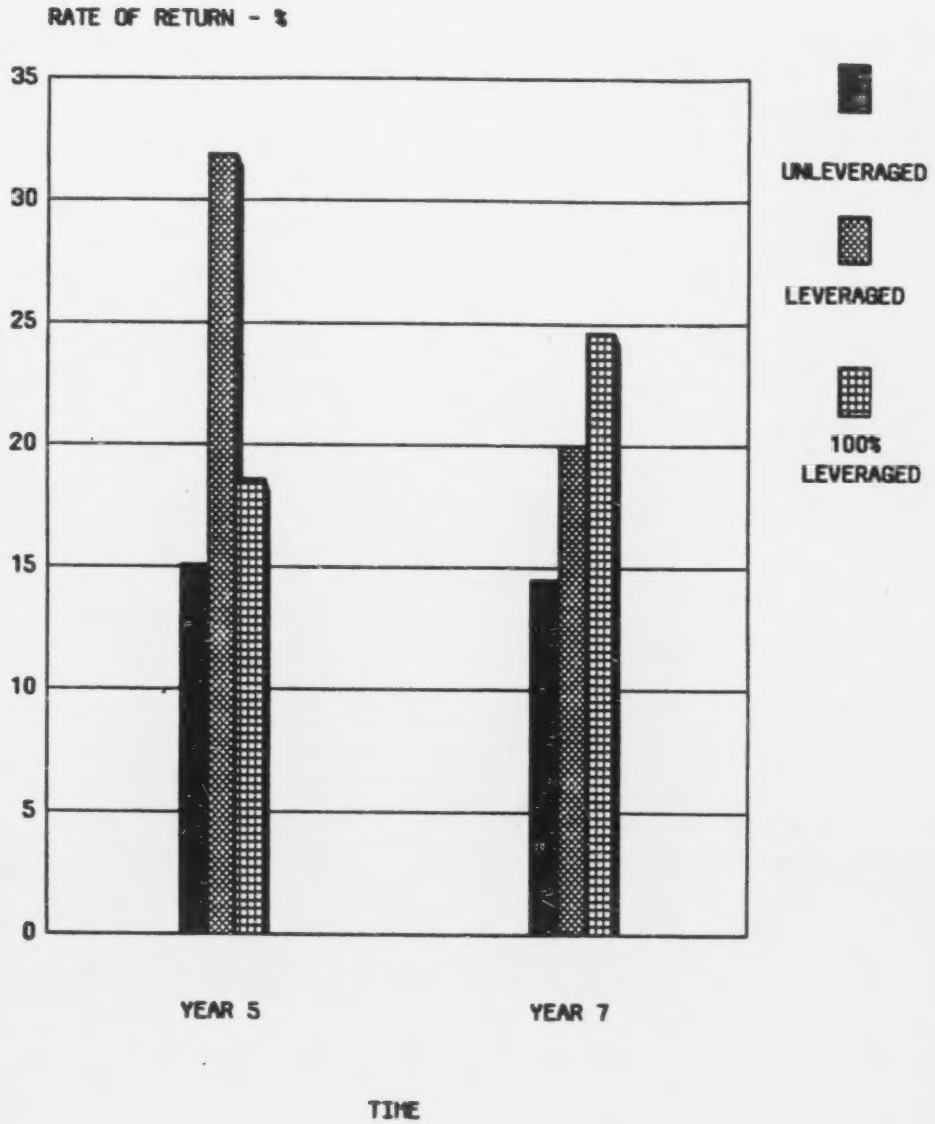
FOUNDER'S COMMON STOCK VALUE



FOUNDER'S RATE OF RETURN



ESOP'S RATE OF RETURN



AMERICAN STERILIZER TRANSACTION SUMMARY

SOURCES AND USES OF FINANCING
(MM$)

USES:

Puchase of outstanding shares for $22.50	$229.4
Cancellation of Stock Options	1.6
Refinance existing debt	20.7
Payment of transaction costs	11.0
	$262.7

SOURCES:

Existing Cash		$32.6
Bank Loans		185.1
Subordinated Debt - Bristol Myers		30.0
Equity Investment	- Management	10.0
	- Kelso	2.5
	- First Boston	2.5
		$262.7

DEBT REPAYMENT
(MM$)

Acquisition Debt	Post Closing	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Bank Revolver	$ 31.7	$ 21.6	$ 25.7	$ 18.9	$ 14.8	$ 25.2	$ 23.8	$(3.8)
Term Loan	153.4	97.7	87.7	72.7	57.7	24.0	-0-	-0-
Subordinated Debt	30.0	20.0[1]	20.0	20.0	20.0	20.0	20.0	20.0
Existing Debt	1.6	1.6	.9	.8	.6	.5	.3	.1
Total	216.7	140.9	134.3	112.4	93.1	69.7	44.1	16.3

[1] Reduction of subordinated debt results from the acquisition of the AMSCO Hall Division by Bristol-Myers

INTEREST COVERAGE
(MM$ except ratio)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Earnings Available For Interest	$53.6	$36.7	$47.3	$45.2	$48.4	$51.7	$55.2
Total Interest Expense[2]	20.4	17.7	15.8	13.1	10.1	6.7	3.2
Interest Coverage Ratio	2.63X	2.07X	2.99X	3.46X	4.79X	7.72X	17.31X

[2] Interest expense throughout the projection period was calculated using the following interest rates:

Revolving Credit - 12.75%
Term Loan - 13.75%
Subordinated Debt - 15.00%

COMMON STOCK OWNERSHIP[3]
(at closing 2/85)

CLASS A		Investment	Percentage Ownership
Management		$10,000,000	66.7%
CLASS B			
Kelso		$2,500,000	16.65%
First Boston		2,500,000	16.65%
	Total	$15,000,000	100.0%

[3] The AMSCO transaction was structured utilizing an unleveraged ESOP.

RATES OF RETURN
(As Projected at Closing 2/85)

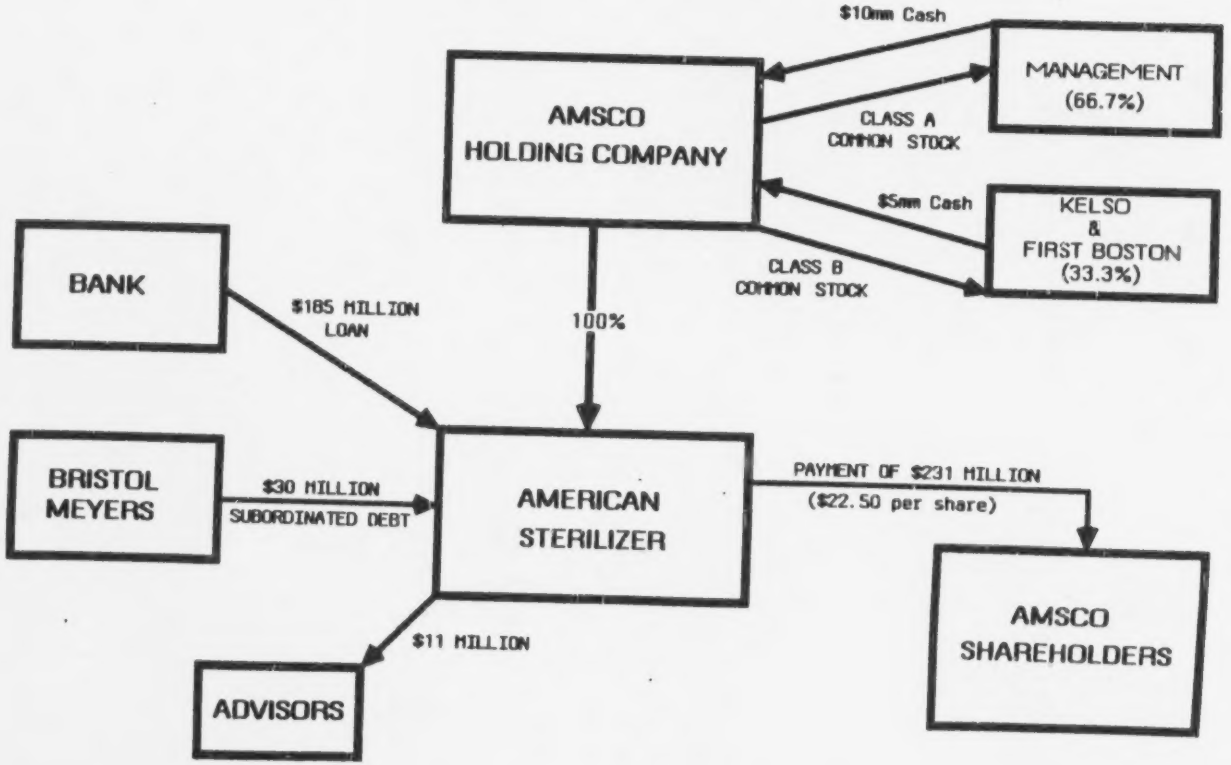
ESOP RATE OF RETURN	Post Closing	Year 1	Year 2	Year 3	Year 4	Year 5
ESOP Contribution	-0-	$23.5[4]	$7.2	$17.0	$16.2	$19.3
Preferred Dividend	-0-	-0-	1.4	4.5	7.4	8.1
Value of ESOP Stock (estimated)[5]	-0-	23.5	32.1	53.6	82.1	101.9
ESOP Percentage Ownership (estimated)	-0-	-0-	-0-	-0-	21.8%	35.3%

ESOP's Rate of Return in Year 5 - 10.1%

[4] Represents a contribution for 1984 and 1985.

[5] Estimated ESOP stock value includes preferred and common stock.

AMERICAN STERILIZER
EMPLOYEE BUYOUT STRUCTURE



BLUE BELL TRANSACTION SUMMARY

SOURCES AND USES OF FINANCING
(in millions)

USES:

Puchase of outstanding shares for $47.65	$470.7
Payment for stock options	5.9
Payment for stock incentive awards	1.7
Repayment of Existing Debt	105.0
Management Notes or Obligations	3.3
Payment of transaction costs	24.8
	$611.4

SOURCES:

Existing Cash	$ 7.0
Bank Revolving Credit	317.0
Senior Notes	75.0
Savings & Loan Debt	75.0
Subordinated Debentures	50.0
Holding Convertible Debentures	12.5
Series A Preferred Stock	55.0
Holding Common Equity	19.9
	$611.4

DEBT REPAYMENT
(in millions)

	Post Closing	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Acquisition Debt								
Bank Revolver	$317.0	$292.6	$244.1	$196.6	$149.2	$ 93.1	$ 42.8	$(11.5)
Savings & Loan Debt	75.0	74.0	73.0	72.0	71.0	70.0	69.0	64.0
Senior Institutional Debt	75.0	75.0	75.0	75.0	75.0	75.0	60.0	45.0
Subordinated Debt	50.0	50.0	50.0	50.0	50.0	50.0	50.0	50.0
Existing Debt	13.6	10.4	7.8	5.2	1.8	1.2	.6	-0-
Convertible Debenture	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5
Total	543.1	514.5	462.4	411.3	359.5	301.8	234.9	160.0

INTEREST COVERAGE
(MM$ except ratio)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Earnings Available For Interest	$145.4	$150.5	$157.2	$173.7	$183.3	$189.6	$196.8
Total Interest Expense[1]	87.3	77.8	69.8	61.8	53.2	43.3	32.0
Interest Coverage Ratio	1.67X	1.93X	2.25X	2.81X	3.45X	4.38X	6.16X

(1) Interest expense was projected using the following interest rates:

Bank Revolver - 16.0%	Subordinated Debt - 17.0%
Savings & Loan Debt - 16.0%	Existing Debt - 8.25%
Senior Institutional Debt - 16.0%	Convertible Debenture - 15.0%

COMMON STOCK OWNERSHIP - Holding Company
(at closing 11/84)

Common Equity	Investment	Shares	Fully Diluted Ownership %
ESOP	$13,500,000	1,350,000	37.85%
Management	7,805,770	780,577	21.9
Kelso	1,214,230	121,423	3.4
Total	22,520,000	2,252,000	63.15
Convertible Income Debentures	12,485,000	1,316,250	36.85
Total	$35,005,000	3,566,236	100.0%

RATES OF RETURN
(As Projected at Closing 11/84)

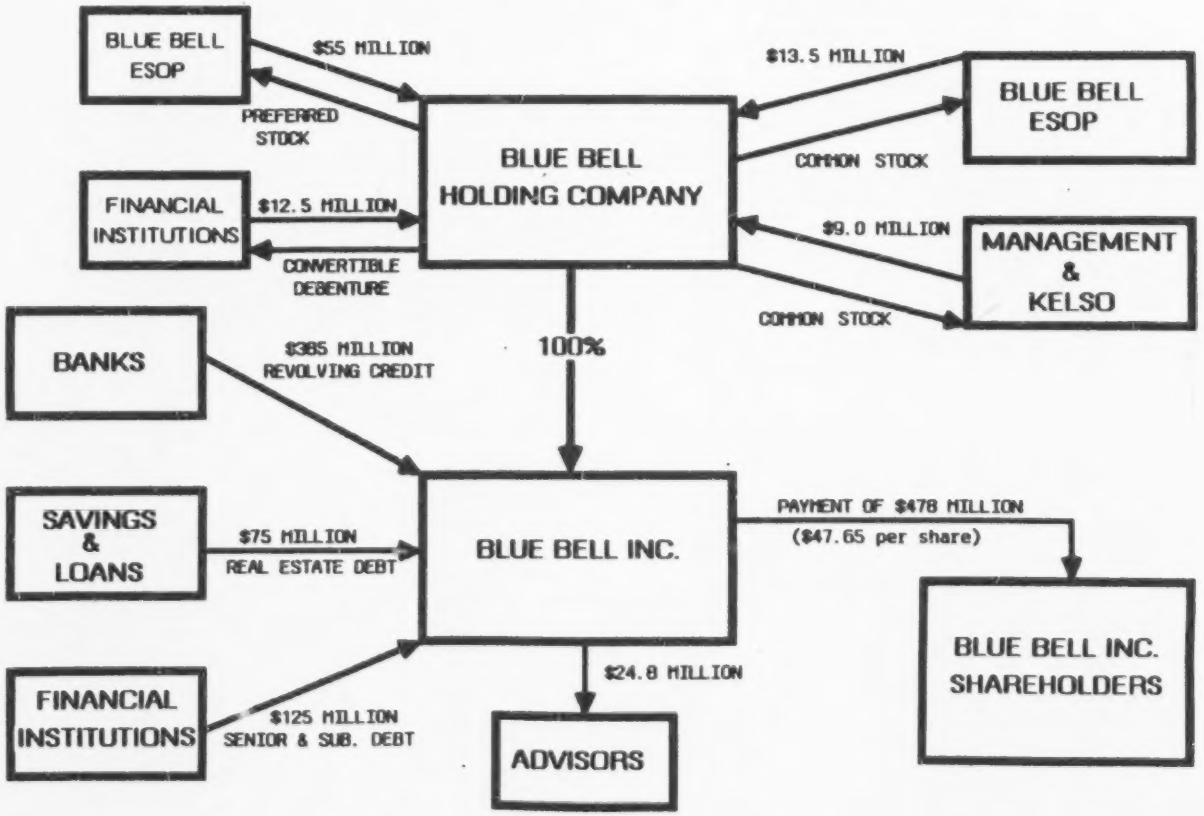
ESOP RATE OF RETURN	Post Closing	Year 1	Year 2	Year 3	Year 4	Year 5
ESOP Contribution	—	$15.8	$14.9	$14.8	$14.6	$14.4
Preferred Dividend	—	8.3	10.1	13.9	18.2	20.4
Value of ESOP Stock						
- Preferred	55.0	79.1	104.1	132.8	165.6	200.4
- Common	12.0	58.6	82.7	104.3	141.2	177.7
ESOP Percentage of Common Ownership	37.85%	37.85%	37.85%	37.85%	37.85%	37.85%

ESOP's Rate of Return in Year 5 - 29.0%

Notes:

1. The Blue Bell transaction was completed without the termination of any existing pension plans.
2. An existing profit sharing plan was converted into an ESOP.

BLUE BELL INC.
EMPLOYEE BUYOUT STRUCTURE



DAN RIVER TRANSACTION SUMMARY

SOURCES AND USES OF FINANCING
($000's)

USES:

Payment of $22.50 per share to common stockholders	$134,198
Payment to holders of Preferred Stock	7,084
Payment to holders of Convertible Subordinated Notes	8,308
Transaction Costs	4,300
	$153,890

SOURCES:

Bank Loan to Holding Company		$148,890
Equity Investment	- Management	3,600
	- Kelso	1,400
		$153,890

DEBT REPAYMENT
(000's)

	Post Closing	Year 1	Year 2	Year 3	Year 4	Year 5
Acquisition Debt						
Bank Revolver	$ 38,082[1]	$ 33,887	$ 32,910	$ 39,732	$ 42,930	$ 49,725
Term Loan	154,376	84,888	73,934	57,894	38,000	7,255
Existing Debt	101,787	91,091	83,392	71,699	63,649	55,465
Total	$294,245	$209,866	$190,236	$169,325	$144,579	$112,445

(1) Includes $14,082 of existing short term notes.

INTEREST COVERAGE

	Year 1	Year 2	Year 3	Year 4	Year 5
Earnings Available For Interest	50,744	47,471	48,986	50,520	52,081
Total Interest Expense[2]	32,896	28,147	25,910	23,149	19,888
Interest Coverage Ratio	1.54X	1.69X	1.89X	2.18X	2.62X

(2) Interest expense on all acquistion debt is calculated using a 17% rate and assuming that principal payments on Long Term borrowing are made at year end. The interest rate on the existing debt is 10% on $20 million and approximately 9.0% on the remainder.

COMMON STOCK OWNERSHIP - Holding Company

CLASS A	Number of Shares	Percentage Ownership	Investment
ESOP	4,888,889	70.0%	$110,000,000 Note
Kelso	33,276	.5%	748,710
CLASS B			
Management	1,747,573	25.0%	$3,600,000
Kelso	316,160	4.5%	651,290
Total	6,985,898	100.0%	$115,000,000

RATES OF RETURN
(As Projected at Closing 5/83)

ESOP RATE OF RETURN	Post Closing	Year 1	Year 2	Year 3	Year 4	Year 5
ESOP Note (000's)	$110,000	$75,255	$52,903	$29,061	$2,939	-0-
Class A Price per share	14.17[3]	22.50[4]	25.95	28.98	33.05	38.01
Value of ESOP Stock	110,000	110,000	126,867	141,680	161,578	185,827

ESOP's Rate of Return In Year 5 - 21%

CLASS B RATE OF RETURN

	Post Closing	Year 1	Year 2	Year 3	Year 4	Year 5
Class B Price per Share[5]	-6.83	$1.50	$4.95	$7.98	$12.05	$17.01

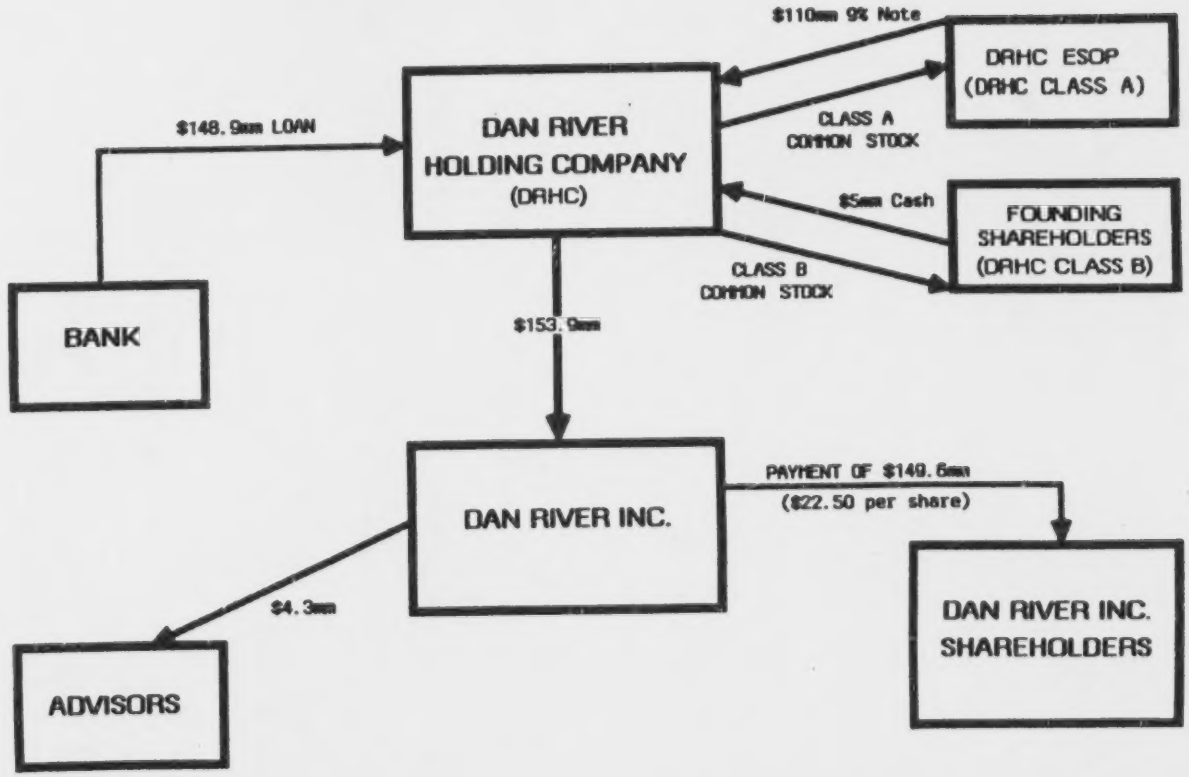
Class B Rate of Return In Year 5 - 52.5%

(3) Appraised fair market value of Class A Stock, Post Closing

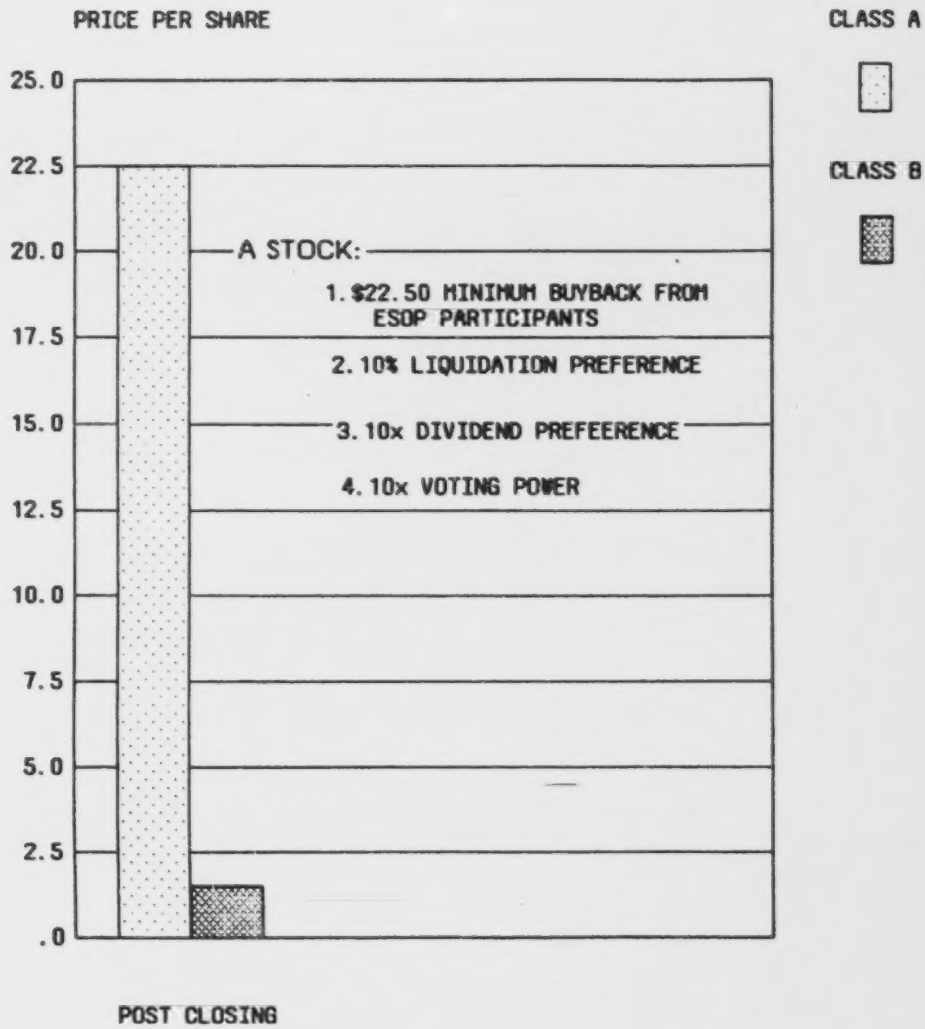
(4) $22.50 is the guaranteed floor value for the ESOP stock. Amounts for Year 2 and thereafter are equal to projected fair market value.

(5) There is a fixed price differential of $21.00 between the Class A and Class B stock.

DAN RIVER INC.
EMPLOYEE BUYOUT STRUCTURE



CHARACTERISTICS OF CLASS A & B STOCK

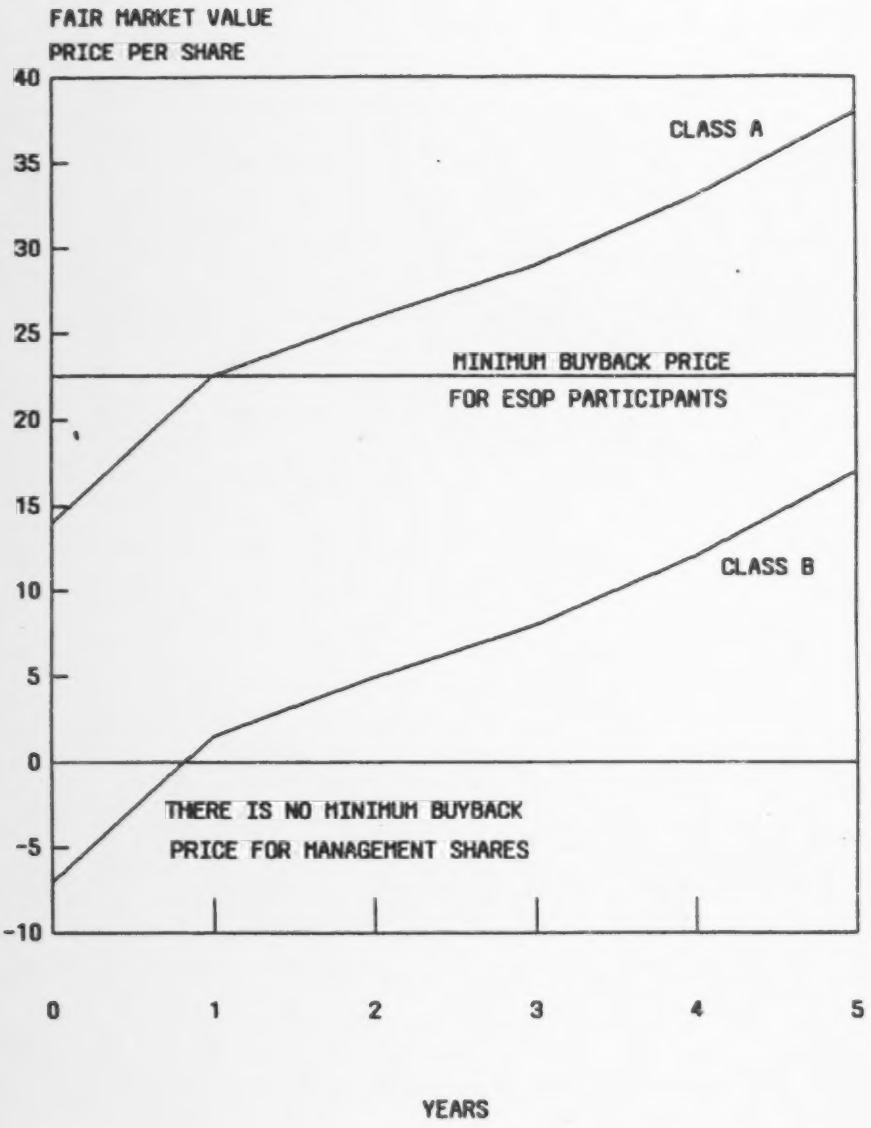


NOTE:

THE CLASS A & B STOCK HAVE A FIXED VALUATION DIFFERENTIAL OF $21 PER SHARE. THEREFORE, THE A STOCK WILL ALWAYS BE WORTH $21 PER SHARE MORE THAN THE B STOCK.

PROJECTED STOCK PRICES

(CLASS A and CLASS B)



RATES OF RETURN
(As Projected After 1st Year of Operations)

ESOP RATE OF RETURN	Post Closing	Year 1	Year 2	Year 3	Year 4	Year 5
ESOP Note (000's)	$110,000	$75,255	$52,903	$29,061	$2,939	-0-
Class A Price per share	$14.17(1)	$10.50(2)	$12.44(2)	$13.90(2)	$15.84(2)	$18.22(2)
Value of ESOP Stock(3)	69,276	51,333	60,818	67,956	77,440	89,076

ESOP's Rate of Return In Year 5 - -0-
based on the minimum buyback price

CLASS B RATE OF RETURN

	Post Closing	Year 1	Year 2	Year 3	Year 4	Year 5
Class B Price per Share(4)	($6.83)	($10.21)	($8.56)	($7.10)	($5.16)	($2.78)

Class B Rate of Return In Year 5 - Negative

(1) Actual appraised fair market value of Class A stock at the closing.

(2) Estimated appraised fair market value of Class A stock, based on actual performance to date and subsequent performance along the lines of the original projections.

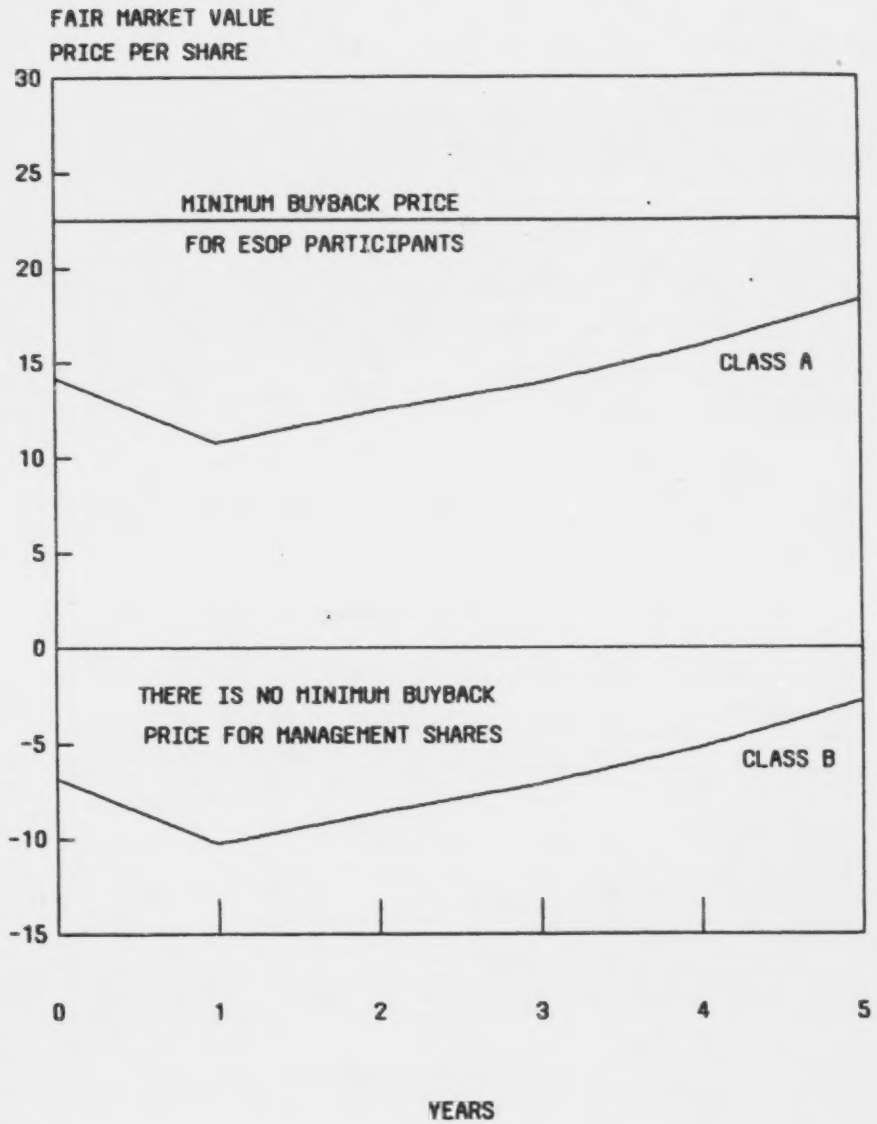
(3) This amount represents the estimated appraised fair market value share of the ESOP stock, times the number of shares acquired by the ESOP. However, Dan River's ESOP provides that each terminating ESOP participant will receive a price of not less than $22.50 per share.

(4) There is a fixed price differential of $21.00 between the Class A and Class B stock.

Note: The Class B shareholders paid $2.06 per share in cash at the closing. Due to the $21 fixed price differential these shares would have no value in Year 5.

PROJECTED STOCK PRICES

(CLASS A and CLASS B)



RAYMOND INTERNATIONAL TRANSACTION SUMMARY

SOURCES AND USES OF FINANCING
(in millions)

USES:

Payment of $27.50 per share to common stockholders	$157.0
Payment to holders of Raymond Preferred Stock	9.9
Repayment of Existing Debt	29.7
Payment of Stock Options	1.8
Transaction Costs	8.5
Funding for Working Capital and business expenses	12.3
	$219.2

SOURCES:

Bank Borrowings	$180.0
Thrift Plan Investment in Series A and B Preferred Stock	27.3
Subordinated Debt and Series C Preferred Stock	6.5
Investment in Class B Common Stock	5.4
	$219.2

DEBT REPAYMENT(1)
(in millions)

	Post Closing	Year 1	Year 2	Year 3	Year 4	Year 5
Bank Revolving Credit	$180.0	$129.1	$111.7	$ 86.8	$ 50.2	$ 5.5
Italian Exim Debt	19.3	13.8	8.3	2.8	-0-	-0-
Subordinated Notes	5.0	5.0	5.0	4.0	2.0	-0-
Total	204.3	147.9	125.0	93.6	52.2	5.5

INTEREST COVERAGE(1)
(MM$ except ratios)

	Year 1	Year 2	Year 3	Year 4	Year 5
Earnings Available For Interest	$ 54.4	$ 47.4	$ 59.5	$ 64.4	$ 68.9
Total Interest Expense	19.5	15.9	12.6	8.0	2.4
Interest Coverage Ratio	2.79X	2.98X	4.72X	8.1X	28.7X

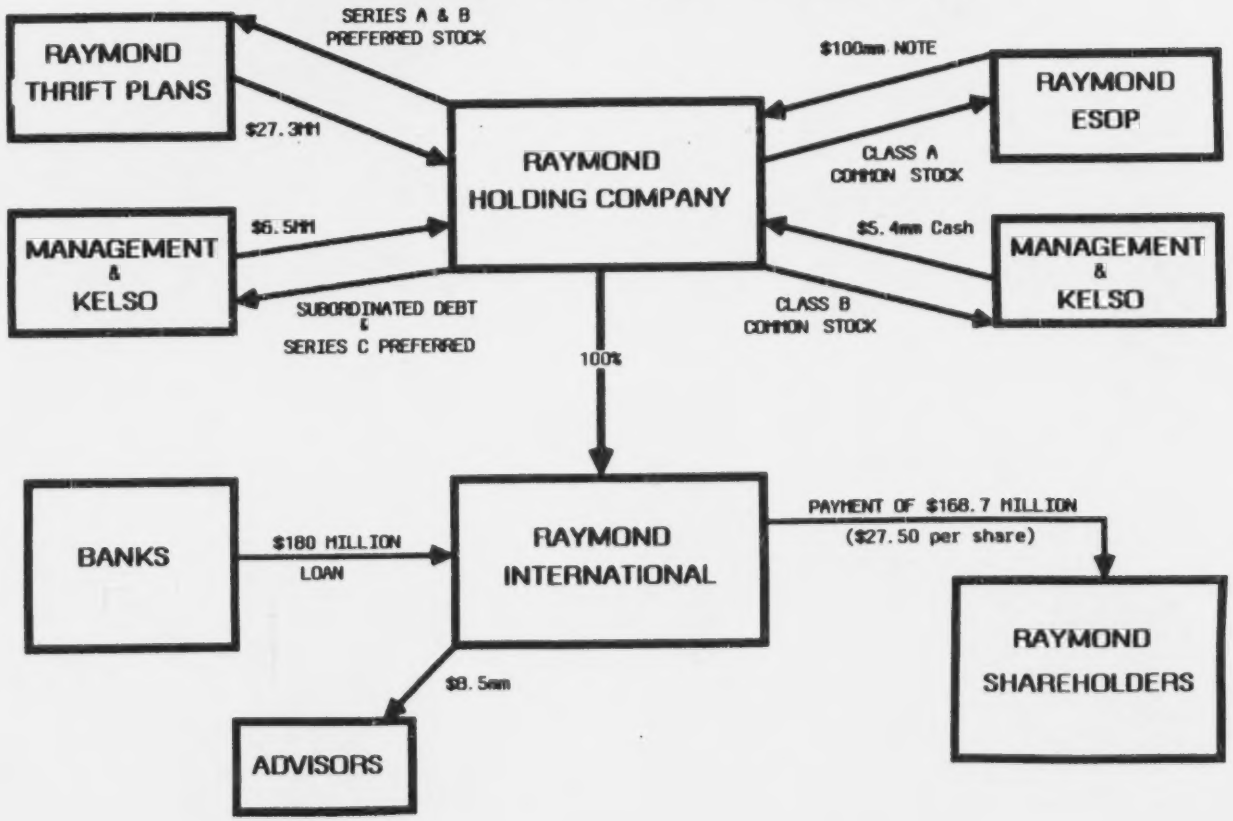
(1) Based on Scenario A Operating Projections, as provided in the Raymond Proxy Statement dated 9/15/83.

COMMON STOCK OWNERSHIP - Holding Company

Class A	Investment	Shares
ESOP	$10,000,000 note	10,000,000
Class B[1]		
Management	4,657,000	4,286,635
Kelso	775,000	713,365
Total	$ 5,432,000	5,000,000

(1) There is a fixed price differential of $10.00 per share between the Class A and Class B stock. Therefore the Class A stock will always be worth $10.00 per share more than the Class B stock.

RAYMOND INTERNATIONAL
EMPLOYEE BUYOUT STRUCTURE



KELSO
& COMPANY

RETURN TO AN ESOP IN A LEVERAGED BUYOUT

April 15, 1985

350 Park Avenue • New York, New York 10022 • (212) 751-3939
San Francisco • Newport Beach

HYPOTHETICAL TRANSACTION
Sources and Uses of Financing

Uses:	
Purchase stock	$100,000
Refinance existing debt	-0-
Closing costs	4,500
Total	$104,500
Sources:	
Existing cash	$ -0-
Interest bearing debt	94,500
Common equity	10,000
Total	$104,500

ASSUMPTIONS FOR HYPOTHETICAL TRANSACTION

Transaction

Purchase Price	$100 million
Founder's Equity Investment	$10 million
Total Acquisition Debt	$94.5 million
Transaction Costs	$4.5 million
Interest Rate on Debt	$13.0%

Company

Net Sales	$180 million, increasing 5% per annum
Operating Profit Margin	13.9% through projection period
ESOP Contribution	$10 million, growing at 5% per annum
Income Tax Rate	46%
Capital Expenditures	$6.0 million per year
Depreciation	$6.0 million per year

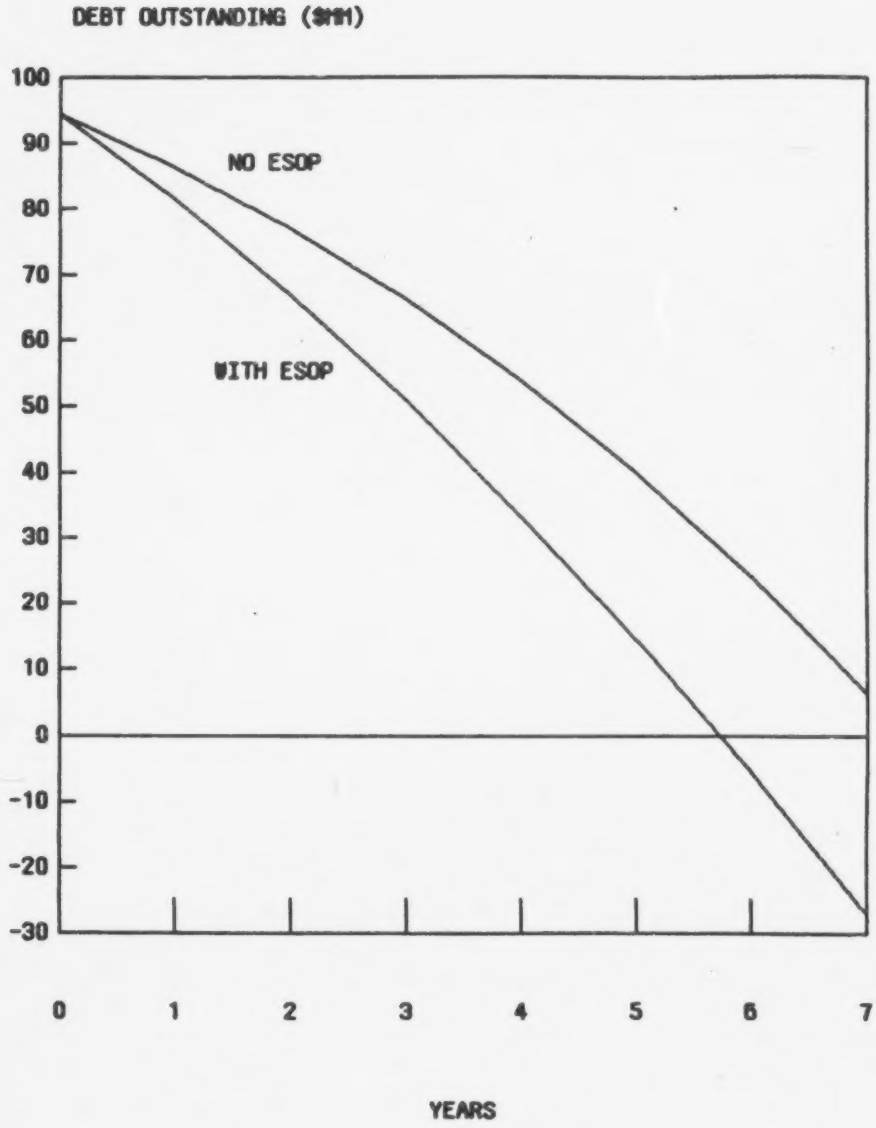
HYPOTHETICAL SCENARIO ANALYSIS

(000's)

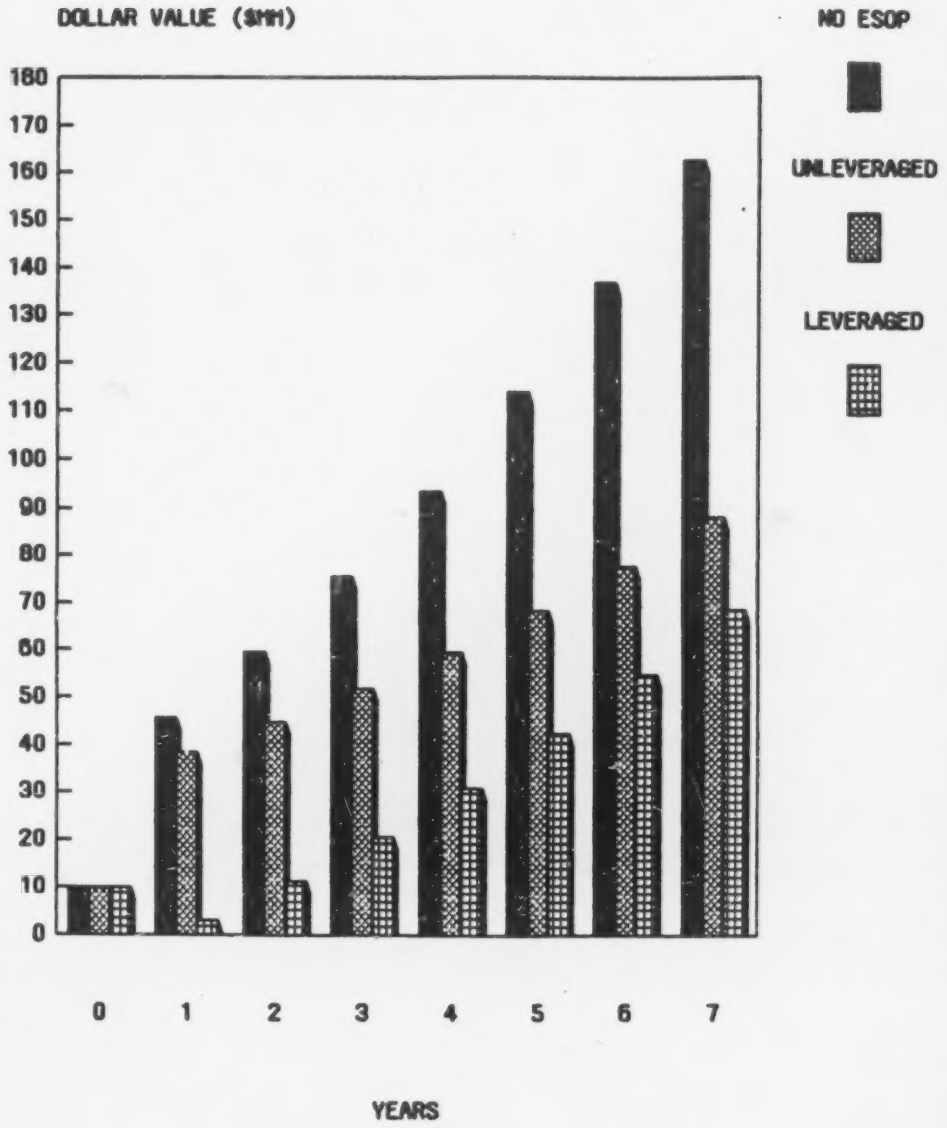
NO ESOP	Closing	5th Year	7th Year
Debt	$94,500	$39,750	$ 6,461
Equity	10,000	57,237	93,835
Common Stock Price	$10.00	$113.93	$162.44
Rate of Return	—	62.7%	48.9%
Total Common Value	$10,000	$113,934	$162,442
ESOP Value	-0-	-0-	-0-
ESOP Ownership %	-0-	-0-	-0-
UNLEVERAGED ESOP	**Closing**	**5th Year**	**7th Year**
Debt	$94,500	$14,454	($ 27,136)
Equity	10,000	89,150	131,674
Common Stock Price	$10.00	$68.12	$88.18
Rate of Return	—	46.8%	36.5%
Total Common Value	$10,000	$132,607	$188,685
ESOP Value	-0-	64,510	100,525
ESOP Ownership %	-0-	48.6%	53.3%
Rate of Return	—	15.1%	14.5%
LEVERAGED ESOP	**Closing**	**5th Year**	**7th Year**
Debt	$94,500	$14,454	($ 27,136)
Equity	10,000	89,150	131,674
Common Stock			
-Class A	$100.00	$169.34	$225.41
-Class B	$21.40	$90.74	$146.81
Rate of Return			
-Class A	—	31.9%	20.0%
-Class B	—	33.5%	31.7%
Total Common Value	$10,000	$132,607	$188,685
ESOP Value	-0-	$90,207	$120,076
ESOP Ownership %	53.3%	53.3%	53.3%

DEBT OUTSTANDING

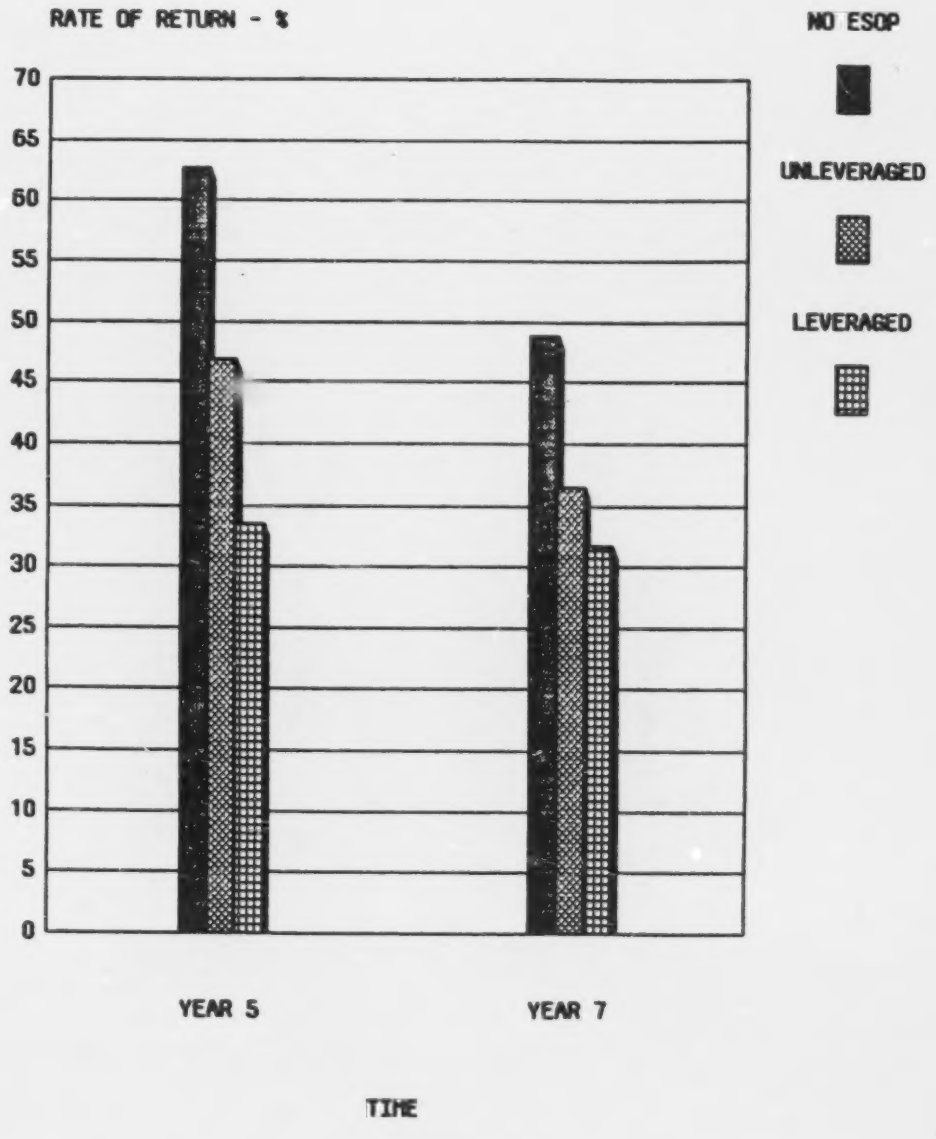
NO ESOP VS. WITH ESOP



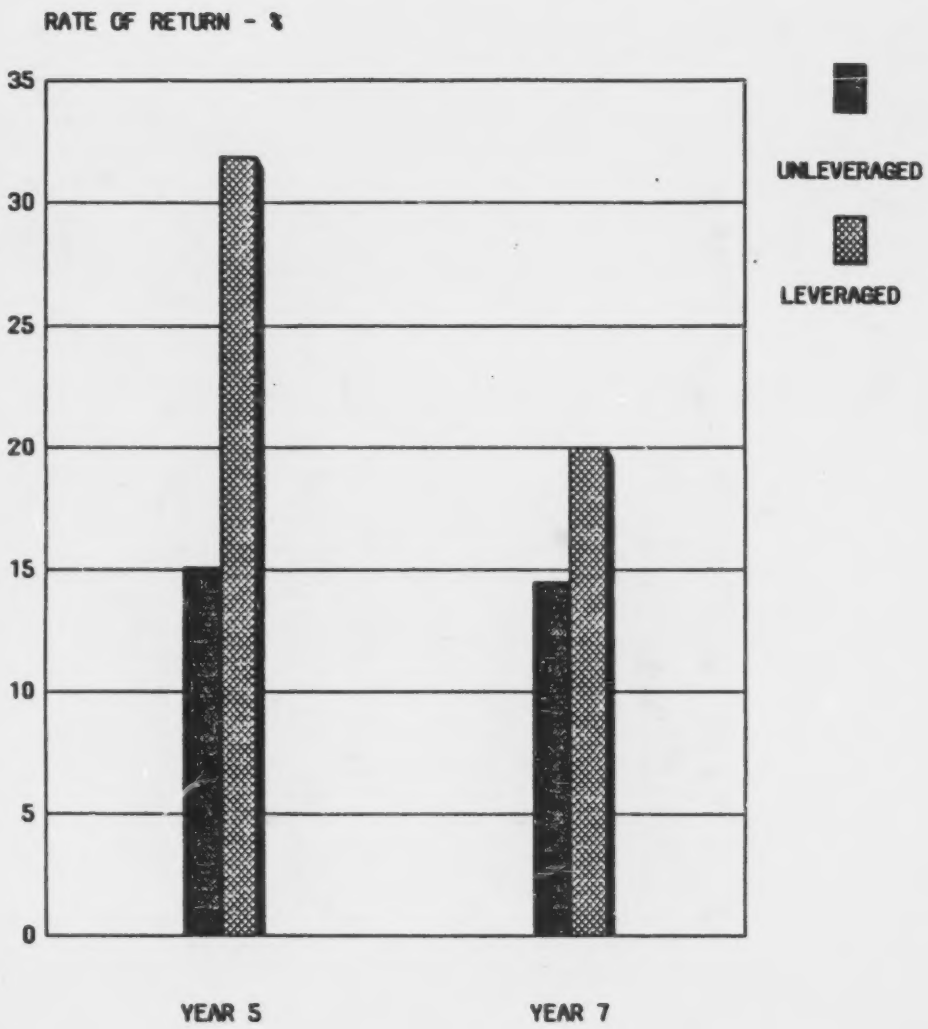
FOUNDER'S COMMON STOCK VALUE



FOUNDER'S RATE OF RETURN



ESOP'S RATE OF RETURN



RESPONSE TO BUSINESS WEEK COVER STORY

ESOPs: REVOLUTION OR RIPOFF?

The following is presented in response to the Business Week article of April 15, 1985 entitled ESOPs: Revolution or Ripoff?. This information in reply is submitted in annotated form, with each number relating to the corresponding number marked on the attached copy of the article.

No. 1

Although W. L. Gore & Associates, Inc. is an excellent example of good labor relations and demonstrates the results of enlightened management practices, the Employee Stock Ownership Plan (ESOP) presently holds only 10% of the stock of the company. The Gore family owns 80% of the stock and therefore has overwhelming control. Apparently (this is not clear from the article) the ESOP was not leveraged, but acquired its stock over time from annual contributions. The company has been, and continues to be, entrepreneurial in nature, with growth and earnings attributable largely to the innovative development of technology in the use of teflon polymer. Certainly, the Gore management and owners are to be congratulated for their well deserved success, as well as their willingness to share some of the fruits of the enterprise with their employees.

However, this can hardly be compared, on any fair basis, with the 100% leveraged buyout of Dan River Inc. using ESOP financing techniques. There the employees acquired more than 80% (not 70% as stated in the article) of the equity of the company in a single, leveraged transaction. The buyout was precipitated by the hostile takeover attempt of Carl Ichan, who had initiated a tender offer for the company's stock. Although Dan River had invested heavily in capital improvements which made its facilities among the most modern and efficient in the world, severe and continuous market pressures

from foreign imports have obviously adversely affected its business, in much the same way other American textile firms have all been impacted. Dan River is a company in a mature industry driven by economic forces beyond its control. Gore is a company in the process of continued growth and prosperity; Dan River, a company which is part of a troubled industry.

No. 2

This paragraph, by itself, makes an overwhelming case in favor of the ESOP. Despite all of the criticism directed against the ESOP leveraged buyout which appears later in the article, the writer acknowledges that the process of capital formation in millions of employees continues at an accelerating pace. From the very beginning, this has been clearly the most important objective to be obtained from the use of ESOP financing techniques. Hopefully, ESOP's will cover more than 25% of all U.S. workers by the year 2000. But, even if the writer's estimates are not exceeded, the case for ESOP has been made -- a massive diffusion of capital ownership will have been realized, and tens of millions of American workers will have the opportunity to participate in the economy as capital owners.

The writer attributes the current rapid increase in number of ESOP's to the recent tax incentives voted by Congress in 1984. Clearly these incentives will foster ESOP growth. But, as demonstrated by the graphs which appear on page 102 of the article, the trend had been developing over a number of years. The evidence would indicate that from 1975 through 1984, ESOP's have been growing at an accelerating rate.

No. 3

The nature of the question posed in this paragraph foretells the point of view taken in the balance of the article, and indicates the author's

misunderstanding of the nature and purpose of the ESOP. Will the ESOP "continue to save jobs and benefit workers as a spread the wealth movement?" The very question presumes that the primary purpose of ESOP is to save jobs and, secondarily perhaps, to spread the wealth. All historical evidence, beginning with the first ESOP buyout in 1956, and including all of the tax incentive legislation adopted by Congress from 1974 through 1984, supports the proposition that the ESOP was designed and is intended as a technique of corporate finance for the purpose of building capital ownership into employee constituencies.

The saving of jobs would at best be an incidental result of an ESOP driven acquisition, and then only in relatively rare cases, such as Weirton Steel Corp. The writer then asks whether the ESOP will "degenerate into a management scheme to profit at the expense of employees?" He follows with the punch line -- "In short, are ESOP's a revolution or a ripoff?" Although these issues will be addressed in more detail later, it is clear that the writer is really not asking a question, but merely expressing a point of view.

It is virtually impossible for the ESOP related transaction to be used as a management scheme to profit at the expense of employees. The ESOP cannot be used to generate wealth for management investors in an ESOP leveraged buyout without the concomitant creation of substantial capital for all employees. Moreover, the use of the word "ripoff" as part of the title of a cover story of this importance would inevitably lead the reader to conclude that the reporter had indeed identified or uncovered transactions where "ripoffs" had actually occurred. Or at the very least, the writer should have been able to zero in on at least one case where a "ripoff" could be identified and so labeled. Even after reading the entire article over and over again, one has great difficulty finding any illustration of a "ripoff". Presumably, the two cases where the Department of Labor intervened are examples of abuses

or "ripoffs" in which management stands to profit at the expense of employees. Although the nature of the Class B common stock acquired by management in the Raymond case will be discussed later, as well as the structure and allocation of equity in the Blue Bell transaction, changes which were made in the equity allocation after the negotiations with the Department of Labor (DOL) were as follows:

1. In the Raymond transaction, no reduction was made in the number or percentage of shares allocated to management. The value of the management interest was capped at 20% of the ultimate value of the corporation. However, under no projected operating scenario developed by Kelso did the management equity reach a value of 20%. Hence the cap placed on potential management gain did not "bite" under any reasonable earnings projection. The principal change made in response to DOL intervention involved the allocation of shares to the Thrift Plan based upon the election of Thrift Plan participants to reinvest assets resulting from employer contributions. The end result was that the equity allocated to the Thrift Plan was increased largely at the expense of the ESOP, which acquired all of the Class A common stock (representing 65% of all shares, including Class A and Class B Common, and more than 75% of the ultimate value of all common.) Potentially, this change involves, if the company is successful, a massive transfer of wealth from the ESOP participants to the Thrift Plan participants. Unfortunately, the Thrift Plan participants, in general, consist of the more highly compensated engineers employed by the Kaiser Engineering subsidiary of Raymond. ESOP participants, on the other hand, come from a far broader constituency, which includes clerical,

secretarial and others whose compensation levels are considerably lower.

2. Changes in the Blue Bell structure, made after a weekend of negotiations with the DOL, resulted in a reduction of the management interest from 25% to 21%. A change of this magnitude hardly represents an abuse or "ripoff". Moreover, the proposed structure prior to DOL intervention required that management place 20% of its stock into an escrow account to be retreived only after the company had paid off substantially all of its acquisition debt. The settlement arrangement made with DOL, although reducing the management percentage to 21%, did away with any escrow provision.

No. 4

Current and projected revenue losses as estimated by the Office of Management and Budget are not realistic. They obviously presume that all ESOP financing following the Deficit Reduction Act of 1984 will take advantage of the interest exclusion provision available to lending institutions on qualified loans to ESOP's. However, there is presently little or no appetite by lenders for loans carrying this exemption since few banks or insurance companies are currently taxpayers. Kelso has been involved in only one transaction where this type of financing was obtainable, and then only with considerable difficulty was the loan widely syndicated. The market simply doesn't exist for these types of loans at this time and, therefore, the provision which was most seriously resisted by the Treasury, although of great potential value, has not resulted in the availability of low interest loans for ESOP driven transactions. In Kelso's judgment, the major part of revenue losses attributable to the ESOP come from the PAYSOP which provides a tax credit

of one half of one percent of annual payroll. The article correctly states that hundreds of companies use PAYSOP's for tax credits alone. It is clearly not a financing tool and will not build substantial ownership into employees, even after a long period of time. Annual allocations to a $15,000 per year employee, for example, amount to only $75.

No. 5

Again the writer presumes the revenue losses attributable to ESOP's are only worthwhile if offset by "job creation." This reemphasizes his failure to understand the real nature and purpose of the ESOP as a technique of corporate finance to build capital ownership into a capitalless constituency.

No. 6

The serious issues of fairness to which the writer refers in the cases of Blue Bell and Raymond have been addressed above, and the changes made after the intervention by DOL were summarized.

No. 7

True, the ESOP is normally represented by an ESOP trustee, which is required under the law covering all qualified plans, including pension plans and profit sharing plans, as well as ESOP's. The trustee has a fiduciary duty to all employee participants, and undertakes to assure that the plan is operated in accordance with the law and for the exclusive benefit of the participants. Although the trustee may be a company official, this is rarely the case. Normally, a national bank or trust company acts as the trustee and is either totally independent or is directed by an ESOP administrative committee. Where the bank serves as a directed trustee, the ESOP

committee assumes the primary fiduciary obligation. Potential violation of fiduciary standards comes within the purview or jurisdiction of DOL under ERISA, and DOL has both the authority and power to bring appropriate legal action to remedy transactions it deems abusive. Although Kelso has completed hundreds of ESOP transactions since the ESOP was first codified under the Pension Reform Act of 1974, DOL has never brought any action challenging any element of a single transaction. No law or regulation or court case for that matter requires or even intimates that the ESOP should be represented other than by the trustee normally appointed for this purpose. If the trustee breaches its fiduciary duty to employees by engaging in or permitting a transaction prohibited under the law, or not deemed to be for their exclusive benefit, it faces severe penalties, and an action against the trustee may be brought by any plan participant or by DOL. However, after the intervention of the DOL in the Raymond case, a procedure evolved which provides for representation of the ESOP by an independent financial advisor and independent counsel. Another accepted alternative is to appoint a non-directed or independent trustee for the ESOP who may or may not engage the services of a financial advisor and counsel. This procedure is similar to that followed by Boards of Directors who are called upon to consider acquisition proposals which include members of the management group and/or the Board itself. The Board will appoint a committee of independent directors who may engage an independent financial advisor and counsel. All matters involving the buyout proposal are directed to and determined by this committee. There are no laws or regulations which call for such an independent committee; the procedure was developed after the Securities and Exchange Commission intervened in a proposed "going-private" transaction involving members of management. Incidentally, Kelso endorses the concept of independent financial and legal representation of an ESOP in a leveraged buyout transaction.

The writer refers to the anonymous "critics" who charge that "management and outside investors" frequently "slice off extra generous portions of stock and voting control at the workers' expense -- usually without giving the workers a voice in the decision, even when their pension plans are terminated." Kelso is not aware of a single case or transaction where this has been done. Certainly neither the Raymond nor Blue Bell case gives any support to such a charge. In Blue Bell, guidelines developed in the Raymond case were followed and an independent ESOP committee was appointed. That committee in turn employed the services of an independent financial advisor and counsel.

No. 8

Presumably by stating "such abuses are spurring action by the Labor Department," the writer refers to the charges of the critics that managements and outside investors slice off extra generous portions of stock and voting control at the workers' expense. He then goes on to state that to protect the rights of the ESOP participants from these abuses, the Department intervened in the Raymond and Blue Bell ESOP transactions. However, analysis of the action taken as a result of the DOL intervention in these cases demonstrates that no modification was made in the allocation to management in the Raymond case, and a reduction of only from 25% to 21% of the equity was negotiated in the Blue Bell case. How can it be said that either of these cases constituted an abuse amounting to a "ripoff" or any abuse whatsoever?

No. 9

Kelso is not aware of any ESOP leverage buyouts which could properly be classified as MESOP's. MESOP, standing for Management Entrenchment Stock Ownership Plan or Management Enrichment Stock Ownership Plan, is obviously

used in the pejorative sense. What is management entrenchment? Is it a device, a method or a program designed to keep management in place while continuing to direct the destiny of the business enterprise? Over the last several decades, a whole new industry has grown up to develop executive compensation programs, stock option plans, and other similar programs to serve as "golden handcuffs" in order to retain or "entrench" executives and management members. Plainly, this type of entrenchment would appear to be not only acceptable, but desirable. Because of the use of the term "management entrenchment" in the pejorative sense, by implication it must be assumed that the term only applies to "bad management." Undoubtedly it is in the interest of the corporation and its shareholders to retain "good management" and to provide the various programs which serve as the golden handcuffs. If the ESOP is used as a device to entrench bad management, then it does not serve its intended purpose, and transactions of this kind should be proscribed. However, it is extremely difficult to understand how this can occur in the context of an ESOP leveraged buyout. In any leveraged buyout, whether ESOP or conventional, substantially all of the funds are provided by lending institutions such as banks and insurance companies. Equity funds are furnished by these institutions along with sophisticated outside investors. The investment banker who develops and leads the transaction will also normally invest its own capital in the transaction. The overwhelming majority of the funds needed do not come from the management group.

Once the fundamentals of the business are analyzed and understood by the participants loaning or investing money in the transaction, the issue of overriding importance is the experience and ability of the management group who will direct the operations of the company in the future. If the lenders and providers of the capital, after what is normally an exhaustive review and

analysis of the capabilities of the management team, agree to fund the transaction, the liklihood that the management is incompetent, unethical or dishonest is extremely remote. Of course, it is always possible for an incompetent management group to slip through the intense scrutiny without the incompetence being detected, but this is most unlikely. The key determination in every proposed transaction is the competence and honesty of the management team. Without that, transactions are given little hope of success by providers of capital, be they banks, insurance companies or other investors. Therefore, a total leveraged buyout, ESOP or conventional, is not a vehicle which would entrench bad management. A proposed transaction of this nature would be more likely to detect bad management, since good management is so essential for the funding, consummation and success of the leveraged transaction. As for management enrichment, a study of any of the transactions structured and consummated by Kelso would make a strong case that management can only be enriched if the employee participants of the ESOP are also enriched. It is impossible for management members to be enriched at the expense of employees. The slice of ownership accorded to management groups in Kelso transactions is comparable to, but probably on the low side, of what those same management groups could command if their company was purchased in a conventional leveraged buyout. And, of course, in the conventional leveraged buyout, the employee group in general would not share in the ownership at all.

However, there are situations where ESOP plans could be used for the purpose of the entrenchment of bad management. But these do not involve leveraged buyout transactions where financing depends upon a high level of confidence from lenders and investors who are providing large sums of money relative to the total value of the business being purchased. The use of an ESOP to receive and hold a block of company stock so that voting power may be concentrated and voted to maintain existing control could constitute

abusive management entrenchment. Also certain corporate reorganization plans where substantial voting power is concentrated in the ESOP could be abusive, particularly where all shareholders are not treated equally or where shareholders are subjected to a diminution in the value of their shares. These are not cases involving an ESOP leveraged buyout where all shareholders are accorded equal treatment and cashed out at fair value. Abuses would tend to accompany those situations where all shareholders are not cashed out at fair value, but where, as a result of the transaction or reorganization involving an ESOP, intentional distortion of the concentration of voting power results.

No. 10

It's incredible that the writer insists on returning to the basic premise that the purpose of the ESOP is to provide industrial democracy. Nothing in the history of the ESOP movement, including the original uses of the ESOP to effect corporate buyouts, would suggest that "workplace democracy" is one of its objectives. Again, the primary purpose of the ESOP is to serve as a technique of corporate finance in order to build capital ownership into the employee constituency. Relinquishing control, either on the Board of Directors or the shop floor, the writers would have us believe, should be the result of ESOP implementation in a leveraged buyout. While Kelso has always taken the position that employee participants should have the right to vote their shares on all matters (once the leveraged buyout debt has been substantially repaid), this is a far cry from the concepts of workplace democracy in the Western European codeterminationist sense. Meaningful capital formation in employees is the primary objective of ESOP buyout programs. Such capital formation is best facilitated by the assurance that the business enterprise has the best possible management which can be selected to formulate and carry out the objectives of the enterprise. If employees are to be made capitalists, they should be made "first

class" capitalists, and this means that both the Board of Directors and the operating management of the business should have the background, experience and capability necessary to direct and expand that business in today's competitive environment. Such an objective is not well served by the selection of directors out of the employee constituency, and this principle is confirmed by the same experts in management practices who support the idea of maximizing the employees practical and useful participation in the company. Only if employees are involved in local decision-making, and have proper incentive and freedom to take their own initiative with respect to decisions involving their areas of expertise, will they achieve maximum potential. This principle has long been supported by Peter Drucker, who is generally regarded as one of the early leaders in management science. The same principle has been reconfirmed in management treatises ranging from William Ouchi's book, Theory Z, to Peters and Waterman's book, In Search of Excellence, to Simmons' book, Working Together. However, that employees should be given more say and authority in matters regarding their own areas of expertise, in no way implies that employees should be given a say in the ultimate decision-making. None of the above described authors would advocate such an approach. Drucker, as confirmed in his book, Management, strongly contends that greater employee involvement and input in local decision-making works best when coupled with strong and effective decision-making concentrated in the hands of top management. In Drucker's view, employee involvement should never be confused with the issue of management authority.

The law mandates a pass-through of voting rights on all major corporate matters such as sale of the enterprise, merger, ammendment of charter, liquidation, recapitalization, etc. However, in private companies, not registered with the Securities and Exchange Commission, the law does not mandate a pass-through of voting rights for the election of directors or for ministerial

matters such as the appointment of auditors.

Essentially all leveraged buyout transactions involve an existing private corporation or result in the privatizing of the corporation in the process of buying out the public shareholders. Hence, there is no required pass-through of voting rights for the election of directors in such cases. As a practical matter, banks and other financial institutions would be extremely reluctant to finance a transaction if the Board and management of the business could be changed at any time by the vote of employee/shareholders. Even in a conventional or non-ESOP leveraged buyout, covenants and restrictions in the loan agreements will invariably preclude any change of the management without the approval of the lending institutions. Lenders in leveraged buyout transactions look primarily to the experience and capabilities of the management group in making their decision to provide acquisition financing. Because the substantial amount of the borrowings, i.e. high leverage, raises the overall financial risk, lenders and investors are single minded in their determination to support transactions only if the management group meets very high standards of experience and competence. Often lenders will insist that long term employment agreements be entered into with key members of the management team. Lenders and investors are equally zealous in their demand for a Board of Directors of proven background, experience and expertise. Therefore, it is virtually impossible to finance an ESOP leveraged acquisition without assuring the stability of both the Board and management, at least until such time as substantially all of the acquisition debt has been repaid. A mandated pass-through of voting rights for the election of directors would, in the real world of finance, make the financing transaction very difficult if not impossible.

No. 11

Despite the comments of "mainstream economists" who have derided Kelso's economic ideas, Kelso has managed to call the fundamental and surprising turns in the economy with remarkable foresight. Most mainstream economists, including Samuelson and Thurow, have seen their predictions go awry more often than not. For example, in late 1969 Kelso predicted that the decade of the 70's would see the worth of the dollar decline to a fraction of its value. Commencing as early as the 1950's, his writings have warned that our basic industries would be substantially weakened and ultimately lost as the result of foreign competition. Comments by Samuelson and Thurow demonstrate their lack of knowledge of the purposes and uses of the ESOP as a technique of corporate finance. Thurow proceeds on the incorrect assumption that ESOP's substitute for conventional pension plans. Presumably he favors the use of profit sharing plans as a better means of capital diffusion. However, he fails to understand the comparative advantages of the ESOP:

1. The ESOP establishes a "direct drive" relationship between the success of the business enterprise and the value of the employees' accounts. As the growth and earnings of the business are increased, the value of the employees' accounts will similarly be enhanced. In a profit sharing plan, the company seeks to motivate employees to work harder and smarter to increase the earnings of the business and hence the share of profits allocated to the plan. Thereafter plan contributions are invested by the fiduciary in a diversified portfolio which consists primarily of the stock or securities of other business enterprises. The employee has no knowledge of these businesses or any feeling of confidence in their long term prospects. During the 1970's, profit sharing plans were invested

in the public marketplace on a diversified basis and experienced overall declines of historic proportions. While employees were being congratulated for their efforts in improving their own company's performance, the value of their profit sharing accounts was in constant decline.

2. The level of contributions to an ESOP are generally considerably higher, in the magnitude of two to three times, that of the typical profit sharing plan. The reason is simple. The funds contributed to the plan are reinvested in the securities of the employer. In order to accommodate a transaction in the nature of a leveraged acquisition, companies commit to contribution levels as high as 25% of payroll, which is many times the level of the average profit sharing contribution. Much larger amounts of capital can be formed in the employee constituency where the ESOP is used as a technique of corporate finance and an integral part of a buyout transactior

Absent bankruptcy or failure of the enterprise, ESOP shares could decline substantially in value and still produce capital accummulations for employees far greater than the typical profit sharing plan. And where the ESOP is part of a leveraged buyout, the company normally precommits itself to a high level of ESOP contributions until all acquisition debt has been repaid. Each employee, therefore, can look to a precommitted future stream of ESOP contributions and estimate the amount of capital he will acquire in his account provided he remains with the company. He soon knows that he can directly influence the ultimate value of that capital as a result of his improved performance. These lessons do not come immediately, but develop over time. The full import of the program becomes apparent through both experience and enlightened communication.

No. 12

The "revolution" which the Business Week writer seems to yearn for is again referred to in this paragraph. The revolution actually occurred when the Dan River employees through the ESOP acquired 70% of the total shares outstanding and 100% of the overall value of the company at the time of closing. If and when the Class B common shares allocated to management and Kelso develop value (and they only will if the Class A common shares allocated to the ESOP are enhanced significantly in value), and if the company was sold when debt has been repaid, management and investors would receive between 15% and 18% of the gain.

The writer seems to feel that the change of ownership should mean a basic change in the way the business is operated, and the implication is that this should be in the direction of "workplace democracy". We agree that there is no "token democracy in the workplace." The ESOP cannot be deemed to have "strengthened prospects for job security." Would the writer argue that merely because the enterprise is owned mostly by the employees, jobs should be maintained despite the decreased demand for the company's products -- one of the tenets of some proponents of codetermination? The ESOP certainly does not insulate the company from the effects of foreign competition. Nor can it be expected to guarantee jobs or job security during a business downturn. Perhaps Dan River could have improved its communications program with all employees after the buyout. Changes which had taken place, however, were profound. In a relatively short period of time, the company had gone through a series of events which by their very nature imposed a high level of stress and demand wrenching corporate decisions. Until the day of closing, investment bankers and teams of lawyers moved the transaction from stage to stage. It is only after the buyout has been concluded that management can settle down to the

mundane task of operating the business on a day-to-day basis, but now in an entirely different environment -- that of the private corporation. Traditional, familiar channels of communication are not easily discarded to meet the demands of this new corporate environment. But, in most cases, these fundamental changes do come, and usually on an accelerated basis as the challenges and opportunities for better employee relationships build upon each other. The challenge of operating a leveraged business enterprise in the new environment of a private corporation is often a difficult one, and frequently requires time for the proper adjustments to be made. Dan River's first full fiscal year of operation was completed on December 31, 1984.

No. 13

The description of the two classes of common stock, Class A and Class B, has been covered in a previous footnote (No. 3) in some depth. However, the writer fails to point out something that is very clear from the proxy material -- that is that Kelso's investment was made half in Class A common stock and half in Class B common stock. The writer was advised that if the company met its projected earnings forecasts, the maximum value which management and Kelso could earn was between 15% and 18% of the ultimate value of the business. Further, the Business Week description of the Class A and Class B common stock conveniently omitted the fact that ESOP participants are protected by the minimum repurchase price of $22.50 per share, when even though the shares substantially decline in value immediately upon the closing, simply due to the leverage of the transaction. The Class B common stock has no downside protection nor does the Class A common stock purchased by Kelso.

No. 14

The statement that management decided to move the corporate headquarters and to sell three Greenville plants without consulting employees typifies the accuracy of the balance of the article. The corporate headquarters had been moved and the decision had already been made to close the Greenville plants well before there was any consideration of a leveraged buyout by Kelso or anyone else.

No. 15

This statement is totally erroneous. Does the writer believe that the company has made an outright fabrication when it discloses that benefits to the employees from the ESOP have exceeded the benefits which would have accrued under the pension plans? The second sentence flies in the face of the basic requirements under which the ESOP plan must be operated, and contradicts statements by management as to the information communicated to employees. Perhaps what the writer means is that the company refused to disclose to him financial information concerning the company and its ESOP plan. If so, the company has only acted properly in this regard. Obviously, one of the principal benefits of not being a public corporation is that the company is private.

No. 16

The quoted advice from General Counsel, D. Bruce Shine of UTW, can result only from extraordinary ignorance as to what other ESOP programs provide their participants. The Dan River plan under which the ESOP participated in the leveraged buyout locked in once and for all an assured ownership level which will amount to more than 80% of the ultimate value of the business. When all existing corporate debt has been paid (this should be within ten years from the date of closing), the new capital formed in the employee constituency covered by the ESOP should amount to more than $250 million.

No. 17

The description of the use of the ESOP in the leveraged buyout is at best incomplete and misleading. The ESOP's loan does not replace "most of the institutional money" so that "management doesn't have to share as much control with institutions." The ESOP's participation at best allows a reduction of the amount of institutional participation in the underlying equity. Most, if not all of the equity otherwise allocatable to the institutions inures to the benefit of the workers through the ESOP. The institutions and the commercial banks which provide substantially all the financing exercise significant control not merely through their equity participation, but as a result of the loan covenants which spell out in considerable detail what can and cannot be done by management in the future operation of the business. Seldom if ever do the top managers get 50% of the equity. And, management does not retain control by naming a committee of directors to instruct the ESOP trustee how to vote. Normally the shares are voted by the trustee, who continues to have fiduciary responsibility to all plan participants, at the direction of an ESOP committee appointed by the Board of Directors. In the large leveraged buyout, the majority of the Board of Directors usually consists of outside directors who have no financial interest in the enterprise, are not employees, who are cognizant of their fiduciary duties to both the ESOP participants and all other shareholders. As stated above, existing legislation does not mandate the pass-through of voting rights on the election of Directors, and financial institutions would be reluctant, to say the least, to provide substantially all of the financing for a leveraged acquisition without being assured of continuity of management until acquisition debt has been paid.

No. 18

The statement to the effect that because "management, outside investors and the ESOP all contribute funds, each should receive company stock roughly

in proportion to its investment" cannot be contested. The problem is how to make such a determination. Kelso has always adhered to the principle incorporated into ERISA that the ESOP must receive "adequate consideration" in the amount of stock it receives in return for a loan or for any other consideration. Contrary to the statement covered by this footnote, the courts have never defined the term "adequate consideration" to mean that the ESOP should engage in "arms length bargaining" to get a fair share for the employees. The determination of "adequate consideration" has always been based on the principle of either selling stock in a public company to an ESOP at the current market value or selling the stock of a private company to an ESOP at fair market value as determined by an independent appraiser having expertise in the valuing of securities of a privately held corporation. The DOL and not the courts has embraced the proposition of arms length bargaining where the ESOP participates as one of the acquirers of equity in a leveraged buyout transaction. Although proposed regulations as promulgated in 1976 by the IRS and DOL would have required bargaining on behalf of an independent representative of the ESOP, regulations which were ultimately adopted after intervention by Congress in opposition to the proposed regulations, dispensed with the requirement of an independent representative for the ESOP. At the time the Dan River and Raymond transactions were developed, the only extant authority consisted of the regulations covering loans to an ESOP, and these did not require an independent ESOP representative, but in fact had been substituted for the proposed regulations which would have required independent representation.

For this reason, the intervention of the DOL in the Raymond transaction came as a surprise. Notwithstanding this, Kelso, after considerable reflection as to the roles of the various participants in a leveraged buyout transaction, concluded that it is in the best interest of the employees as well as other

participants in buyout transactions to have independent representation for the ESOP or any other employee plan involved. This effectively reduces the burden placed upon the management group and other principal parties in designing and consummating the buyout. As covered in a previous footnote, independent representation can be secured by the appointment of a totally independent trustee who is therefore "non-directed", or by the appointment of a directed trustee who operates at the direction of a committee which is independent. The independence of the committee is assured by the selection of persons not affiliated with management and not having a financial interest in the ultimate allocation of interests to the participants. Independent financial advisor and counsel should also be made available to the committee acting as plan fiduciary where a directed trustee is involved. Where the trustee is totally independent and therefore non-directed, such trustee will have to make his own determinations with respect to the selection of an appropriate financial advisor and counsel.

No. 19

Schuchert has never aggressively promoted ESOP's to corporate management as a means of avoiding takeovers and gaining control of company stock. Kelso has responded to opportunities in the marketplace in the nature of leveraged buyouts and, on occasion, a leveraged buyout will be recommended to a Board of Directors as an alternative to other defensive strategies.

No. 20

Total cost of the Raymond transaction was $219 million. The ESOP received 65% of the total shares outstanding in the form of Class A common in exchange for a nonrecourse 10% $100 million note. Even if the note were valued at its face amount of $100 million, the ESOP would have paid only 45% of the total

acquisition cost. The ESOP Class A common, however, represents 65% of all of the shares outstanding and more than 75% of the value of all stock outstanding. Raymond did terminate its pension plan in order to recover what would be surplus assets which were then paid into the ESOP. Annuities were purchased for all employees fully guaranteeing their accrued pension entitlements. The ESOP note cannot be repaid within any reasonable time period with what would have been pension contributions. The projected ESOP contributions which will amortize the note are approximately four times the level of the previous pension contributions.

No. 21

Raymond did not borrow "a controversial stock plan from Dan River, involving two classes of stock." Two classes of stock had been used in a whole series of Kelso transactions beginning as early as 1974. However, the principles involved in valuing the two classes of stock are substantially similar to those employed in Dan River. The Business Week article concentrates attention on the hypothetical situation where Class A stock would rise from $10 to $40, in which case the Class B stock would increase in value to $30 per share. For this to happen, the overall enterprise value of Raymond would have to increase by more than four times, a highly unlikely supposition. But if this occurred, the value of the ESOP stock would be at least $400 million and the average employee account would be valued in excess of $65,000.

No. 22

Brian M. Freeman's comments are contradicted by all of the basic financial information presented in the proxy and used with financial institutions. The management group could never have acquired up to one-third of the value of

the company. Indeed, a 20% cap, based upon the ultimate value of the management stake, imposes no practical limitation on the value of management shares in any reasonable operating scenario. At about the time acquisition debt will be paid off, Class B shares must be converted to Class A shares on a value for value basis, thus stopping the disproportionate growth of the Class B stock. During the period of growth, however, the value of the management Class B stock never approaches 20% of the overall value of the company. The 20% cap or limitation simply doesn't bite under any foreseeable set of circumstances. If per chance the company happened to experience an extraordinary growth period, unanticipated by the management or investors -- such would be the case if the Class A stock rose from $10 to $40 -- management's share of the ultimate value could amount to almost one-third of the total enterprise value. Unlikely. Probably impossible. But wouldn't this be a wonderful problem?

No. 23

The writer returns to his theme that the employees have no voting power under the existing Raymond plan. As pointed out above, there is a mandated pass-through of voting rights to employees on all major corporate matters. There is no requirement that the vote pass-through be given for the election of the Board of Directors or for other administrative matters. The whole voting rights question has been amply discussed elsewhere (No. 10).

No. 24

This statement is completely erroneous. The capital accounts of employee participants would normally be distributed to them when they leave the company, either as the result of death, retirement or other termination. The law mandates that the employee/distributee receive a "put" option under

which he has the absolute right to require the company to repurchase the shares at the current fair market value appraisal price. Of course, if an employee works until his retirement at age 65, distribution is made at that time. No major corporate actions may be taken, however, without passing through the voting rights on the relevant questions to the employees.

No. 25

The writer errs again when he states that the Blue Bell ESOP purchased $67 million worth of publicly traded shares with the proceeds of a loan. No loan whatsoever was made to the ESOP; its shares were acquired in exchange for shares and cash held in the company's ESOP which existed prior to the buyout transaction. The ESOP purchased its common stock at the same price as other investors and management. The overall ESOP investment will provide a higher rate of return than that afforded outside investors.

No. 26

The DOL did not claim that the ESOP's share was determined by the company rather than by arms length bargaining among the ESOP, management and outside investors. DOL suggested that the financial advisor representing the ESOP, although having expertise as an evaluation consultant, did not have an investment banking background. A settlement was negotiated with DOL within a matter of a few days and resulted in reducing management's share to 21% from 25%, a relatively modest adjustment. But, really, a ripoff?

No. 27

This comment or footnote relates to the insert covering the lower two-thirds of page 106. Kelso concurs with the statement of Lewie G. Anderson, a Vice President of United Food & Commercial Workers (UFCW), that: "There is

no way workers on a meaningful basis can be managers and workers." However, Kelso strongly contends that they can be workers and capital owners on a meaningful basis, assuming, of course, that the well meaning social architects will not prevail in their case for codetermination.

No. 28

Although, as stated previously, it is possible for ESOP's to be used to entrench management against hostile takeover attempts, Kelso knows of no case where this has actually been accomplished. Kelso opposes the use of the ESOP solely to concentrate voting power in a friendly entity. The underlying economic purpose of the transaction, accompanied by a substantial change of ownership, must benefit all shareholders equally. A total acquisition of the business accomplishes such purpose.

No. 29

It is unfortunate, indeed bizarre, that DOL objects to a pass-through of voting rights on unallocated ESOP shares in response to a tender offer, hostile or friendly. Presumably, even if a raider announces his intention of liquidating and dissolving the corporation, thus terminating all employees, the ESOP trustee may consider only the effect on the value of the plan in voting the stock. DOL suggests that it would not object to a pass-through of voting rights on allocated shares on the tender offer question. It reasons that the unallocated shares are really owned by no one and the employees who they may be allocated to in the future are not completely known. For example, new employees will enter the work force and older employees may leave. However, DOL misses the point in either failing or refusing to see that, if the company is sold as a result of the shareholders response to the tender offer, the sale proceeds

from the ESOP stock will be first applied to pay off the balance of ESOP debt, and all remaining proceeds would be immediately allocated to the accounts of the present employees.

No. 30

The writer concludes that "either Congress or the courts must deal with the abuses of ESOP's before the revolution comes." The problem is that the writers failed to make a case that ESOP's are being abused. Considering the thousands of ESOP transactions which the article acknowledges have taken place, one would think the writers would have been able to come up with at least a few solid examples of abuse or "ripoff". To say that Raymond or Blue Bell should be so classified is not justified even from the most biased point of view. Kelso's history in the ESOP movement is well known and can be thoroughly documented, if one has even a casual interest in doing an indepth reporting job on a financing technique that has been widely used since 1956. In hundreds of ESOP cases developed by Kelso, there has not been a single one which resulted in an adverse ruling by the IRS or the DOL or by any court or other administrative agency.

Cover Story

ESOPs: REVOLUTION OR RIPOFF?

THEY CAN SPREAD THE WEALTH TO WORKERS—OR WITHHOLD IT FROM THEM

At W. L. Gore & Associates Inc., a chemical fabrication company in Newark, Del., some 3,000 employees own 10% of the company through an employee stock ownership plan (ESOP). The workers largely manage themselves, and the company is growing at a 25% annual rate. Says Robert J. Barclay, a safety and health team leader: "I want to make sure this company works, and I feel I'm a part-owner because I have a lot to say about my area of expertise."

In Danville, Va., about 8,000 employees own 70% of textile manufacturer Dan River Inc. through an ESOP, but they have no voting rights or other voice in the business. Control is held by managers and outside investors who together own 30% of the company. Complains union official Kim A. Meeks: "The company stamps its cartons with a big 'D' and 'employee-owned.' But most of the people realize that they don't own anything. They're just paying the bill for those big management people to own the company."

These two companies represent the extremes of a remarkable force sweeping American business. Suddenly, the concept of worker as owner is spreading from an enclave in small business to the giant corporation. Millions of employees are gaining direct ownership of stock in their own companies—thus getting a foot in a door that has historically been shut to all but the wealthy few. At that pace, 25% or more of all U.S. workers will own part or all of their companies by the year 2000.

Already, 7,000 companies have enrolled nearly 10 million workers in ESOPs—up from fewer than 500,000 a decade ago. The number of new plans is currently increasing at a 10% annual rate, largely because of lucrative tax incentives voted by Congress in 1984 (table, page 102). Indeed, the U.S. is moving faster than all other Western democracies except Sweden in conferring ownership on workers. In recent weeks, Scott & Fetzer Co. and Parsons Corp. used the unique borrowing power of ESOPs to arrange leveraged buyouts (LBOs) of their companies at staggering prices—$557 million in the case of Parsons. National Can Corp. and Phillips Petroleum Co. tried to use ESOPs to avoid hostile takeovers. Since the early 1980s, between 70 and 100 failing plants and companies, including Weirton Steel Corp. and Hyatt Clark Industries Inc., have been rescued by ESOP-financed worker buyouts. William F. Whyte, of Cornell University, estimates that 50,000 jobs were saved in 60 of those buyouts.

But the ESOP trend is at a turning point. Will it continue to save jobs and benefit workers as a spread-the-wealth movement, or will it degenerate into a management scheme to profit at the expense of employees? In short, are ESOPs a revolution or a ripoff?

> Critics of ESOPs charge that management has found ways to slice off extra-generous portions of stock for itself and outside investors

POTENTIAL ABUSES. As the once-obscure ESOP has become more visible, so have its costs and potential abuses. Because of ESOPs, the federal government will lose $2.5 billion in tax revenues for fiscal 1986 alone, according to the Office of Management & Budget. If the tax breaks remain as they are, ESOPs will cost taxpayers at least $4.4 billion in 1989. Nobody knows how much of that will be offset by job creation.

More important, serious issues of fairness have been raised in ESOPs set up by such companies as Blue Bell Inc., an apparel manufacturer, and Raymond International Inc., a construction firm. In large leveraged buyouts such as these, three separate interests—managers, outside investors, and employees—usually split up ownership of the new company by bargaining for shares on the basis of their investments. But the employees are often represented only by an ESOP trustee, who is frequently a company official. Critics charge that this procedure frequently enables managements and outside investors to slice off extra-generous portions of stock and voting control at the workers' expense—usually without giving the workers a voice in the decision, even when their pension plans are terminated.

Such abuses are spurring action by the Labor Dept., which enforces the Employee Retirement Income Security Act (ERISA). To protect the rights of ESOP participants under ERISA, the department intervened in the Raymond International and Blue Bell ESOP transactions and is now investigating several others that are not yet closed. Without referring specifically to these companies, Morton Klevan, a deputy administrator in Labor's Office of Pension & Welfare Benefit Programs, comments generally: "A lot of ESOPs are really MESOPs—management entrenchment or management enrichment stock ownership plans. If it looks like a MESOP, the odds are it violates the law."

But advocates—and there are many—argue that ESOPs can be a powerful lever in raising productivity. The National Center for Employee Ownership (NCEO) recently studied 360 high-technology companies. It concluded that those sharing ownership with most or all employees grew two to four times as fast as companies whose employees do not own stock. In a study of 52 employee-owned companies in all industries, NCEO found that the best performers were those that made the largest stock payments to workers' ESOP accounts. These companies also had a strong "ownership culture" and gave workers a powerful voice in decisions. "When you put those three things together," says Corey Rosen,

NCEO's founder, "you have companies that have extremely motivated work forces."

Still, ESOPs seldom produce the degree of industrial democracy that their advocates promise. Most managements refuse to relinquish control, either on the board of directors or—particularly in nonunion companies—on the shop floor. Workers in many employee-owned companies gain no voice in workplace decisions and lack the right to vote their stock, especially if the company is privately held and thus not regulated by the Securities & Exchange Commission. In 85% of all companies with ESOPs, studies show, worker-owners do not have voting rights. "All too frequently," says Joseph R. Blasi, who heads a Harvard University study group on worker ownership, "these companies refuse to use employee ownership to its fullest potential by giving employees real ownership rights and practical and useful participation in the company."

The ESOP form of employee ownership is by no means a socialist idea or an extension of the old worker-cooperative movement. It grew out of a "theory of capitalism" advanced more than 25 years ago by Louis O. Kelso, a San Francisco lawyer who founded the Kelso & Co. investment banking firm. The capitalist system, he argued, could be saved only by turning workers into capitalists through stock ownership. To acquire stock, he said, workers needed a credit mechanism to gain access to capital funds. He invented such a mechanism in 1958, when he helped the employees of a West Coast newspaper take over their company. They bought it with a loan, using an existing stock bonus plan as collateral. Thus was born the ESOP.

Kelso's concept appealed to the popu-

list notions of Senator Russell B. Long (D-La.), who has used his power on the Finance Committee to get favored tax treatment and other forms of support for ESOPs in 16 laws since 1974. From the beginning, Congress empowered the ESOP (which is classified as a special type of pension plan) to borrow money for the employer's operations; it also granted a tax break on repaying such a loan. Each year, the company places up to 25% of payroll into its ESOP trust to pay off the loan. It can deduct the entire amount from income—the principal payments as well as the interest.

Until now, employee ownership has met with no opposition in Congress. But the controversy swirling around the big leveraged buyouts financed by ESOPs could cost Long some support for additional tax breaks that he hopes to win before retiring in 1986. Long also vows to fight the repeal of many ESOP incentives as proposed by the Treasury Dept.'s tax reform plan. Two changes alone would increase tax revenues by $1 billion in 1986. One would reduce a company's maximum annual payment to an ESOP from 25% to 15% of payroll. Another would eliminate the payroll-based stock ownership plan (PAYSOP), an ESOP offshoot that permits an employer to contribute one-half of 1% of annual payroll to a stock plan and deduct that amount from corporate income taxes. Hundreds of companies use PAYSOPs for tax credits alone. But according to Kelso, the PAYSOP is not a true ESOP—because it can't borrow money—and should be done away with. "It's a government giveaway, not a financing tool," he says.

Mainstream economists have always derided Kelso's economic ideas. "In the various ESOP utopias," says Paul A. Samuelson, the Nobel laureate economist at Massachusetts Institute of Technology, "the alleged ability to mobilize new bank credit costlessly and with net social advantage is illusory." The bank loan that flows to the ESOP because of a tax incentive might have been used more productively for another purpose, he explains. As for Long's support of ESOPs, Samuelson adds: "People would start using opium to produce cotton shirts if Senator Long gave them an economic incentive to do it."

NOOK AND CRANNY. Even liberal Lester C. Thurow, a colleague of Samuelson, opposes encouraging ESOPs as national policy. He argues that too much wealth is concentrated at the top in the U.S.—48% of all common stock is owned by only 1% of the population—but believes that ESOPs are not a good way to redistribute that wealth. ESOPs often substitute for conventional pension plans, Thurow notes, but are riskier because the retirement benefits depend on the fate of only one company. He favors profit-sharing. Tax experts also question whether ESOPs should get greater subsidies than regular pensions. Says Alvin D. Lurie, a New York lawyer and former Internal Revenue Service official who often dealt with ESOP matters: "I'm not at all sure our tax policy should encourage the ESOP as the primary retirement nest egg."

These public policy concerns, however, have little impact on the increasing demand for ESOPs in every nook and cranny of corporate America. A real boom is under way, partly because of the publicity accorded the large leveraged buyouts. The long fight early this year at Phillips Petroleum Co., where management proposed an ESOP primarily to entrench itself against an attack by T. Boone Pickens Jr., attracted the attention of corporate chief executives. "After Phillips," says Eugene J. Keilen, a partner at Lazard Frères & Co., "if you weren't making a call to talk about ESOPs, you were taking a call to talk about ESOPs."

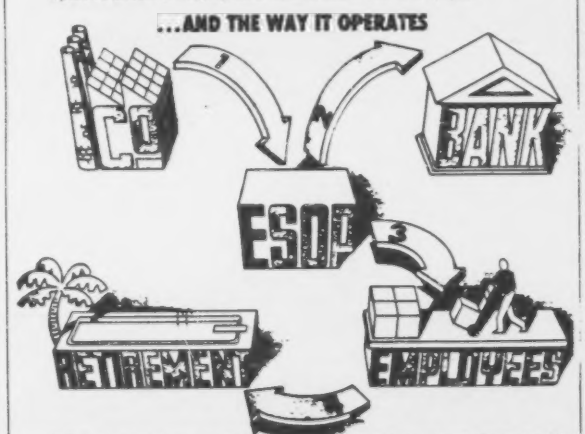
New tax incentives passed in 1984 added to the demand for ESOPs. Banks or insurance companies can now exclude from taxable income half the interest they earn on loans to ESOPs. Large shareholders can sell their stock to a company ESOP and avoid capital gains taxes if they reinvest the proceeds in

HOW A LEVERAGED ESOP WORKS

THE INITIAL SETUP...

1. Bank lends money to ESOP 2. ESOP passes loan to company ... 3. ...in return for an equivalent amount of company stock, which is held in trust for employees

...AND THE WAY IT OPERATES



1. Company makes an annual payment to ESOP from revenues and deducts the full amount from taxable income 2. ESOP uses company contribution to pay off loan. Bank pays taxes on only 50% of interest income 3. Stock is allocated to each employee's ESOP account as loan is paid off 4. When employees quit or retire, they withdraw their stock or sell it, often back to ESOP. New employees join the plan and begin accumulating stock

Data: IW

AT DAN RIVER, 'A LOT OF US FEEL THAT WE GOT TOOK'

After generations of textile workers had toiled at low wages in the dusty red-brick factories that dominate Danville, Va., a revolutionary change seemed imminent in 1983. To avoid a takeover by corporate raider Carl C. Icahn, Dan River Inc. went private in a leveraged buyout that gave the employees a 70% share of the company. But the revolution never came. Disillusioned and angry, the new worker-owners still complain about harassment by dictatorial "overseers," and they suspect that Dan River executives are profiting—and protecting their jobs—at the employees' expense.

BUSINESS WEEK interviews with dozens of employees, hourly and salaried, turned up a near-unanimous feeling that majority ownership has not produced even token democracy in the workplace. Nor has it strengthened prospects for job security. Like all textile manufacturers, Dan River is drowning in a flood of imports. Since 1983 it has closed four plants, sold another, and laid off about 1,000 hourly workers, according to the United Textile Workers (UTW), which represents 5,000 employees. Altogether, Dan River's employment has shrunk to about 8,000, down from 12,000, since management convinced the workers in 1983 that an Icahn takeover would eliminate thousands of jobs. The fear of Icahn was so great that employees voted 58% to 42% to terminate their pension plans and replace them with an employee stock ownership plan.

SHUCK AND JIVE. But since then, lack of information about the company's financial performance has generated widespread suspicion about the plan. One salaried employee calls the ESOP arrangement "a shuck and jive act." An industrial engineer says it is confusing even for salaried workers who have access to more data than production workers. "We can never sit down and figure out what we have and what we don't," she says. "A lot of us feel that we got took."

In setting up the ESOP, Kelso & Co. created two classes of common stock. The ESOP acquired 70% of the company with a $110 million investment in Class A common stock priced at $22.50 per share. A group of 26 managers, along with a Kelso investment fund, put up $4.3 million to buy 30% of the company, mostly in Class B common stock at $2.06 per share. The Class A common stock will always be worth about $22 more per share than management's Class B. But if the company grows, management's stock will get a disproportionate share of the upside. The value of the stock is reviewed once a year by an independent appraiser. If Class A climbs to $26, for example, Class B stock will have a value of about $4—a 100% gain, compared with a 16% rise for the ESOP stock.

In return for the price break on their stock, the managers assumed some risk: If the company is forced to liquidate before a bank loan to the ESOP is paid off in 1992, the workers can redeem their stock before the managers. Employees are able to vote on a merger or sale of the company, but they cannot vote on any other matters, including election of directors. Control still rests with the "dirty 30," the workers' term for Dan River's officers and directors. Employees' stock will be voted by United Virginia Bank, the ESOP trustee, as directed by a management-controlled committee.

In the plants, workers have input into decisions only through an old suggestion-box system. When management decided last year to move the corporate headquarters from Greenville, S.C., to Danville, Va., and sell three Greenville plants, employees learned about the decisions from the newspapers. Questioned about the lack of worker participation, the company states: "While the management will remain the management at this company, more than ever we are all working for one another." Dan River officials repeatedly refused to be interviewed about details of the ESOP or company performance since going private. Management supplies quarterly reports to the ESOP trustee and claims that "to date, benefits to employees from the ESOP have substantially exceeded the benefits which would have accrued under the pension plans." But the company refuses to disclose earnings, sales figures, and the latest stock valuation numbers to employees. Dan River says it made a "modest" profit in 1984 and is currently on schedule with the loan payments. But several salaried employees fear the company could lose money in 1985. And workers complain that layoffs are leaving fewer people to do more work. Says Kim A. Meeks, business agent of UTW Local 248: "Paying back that $100-odd million loan wasn't going to come out of the air. It had to come out of the workers' sweat."

THE UNION'S MEEKS: LOAN PAYMENTS WILL HAVE "TO COME OUT OF THE WORKERS' SWEAT"

CONTEMPT. Local 248 officials decided against having a UTW attorney or accountant study the ESOP before it was set up. "That was our big mistake," admits Local 248 President Arthur F. Daniel. UTW General Counsel D. Bruce Shine says that he learned of the Dan River ESOP several months after workers approved it. "If you are going to get into an ESOP, you sure as hell don't want one like Dan River's," says Shine.

Workers interviewed in Danville expressed open contempt for management. But they would not give their names because they fear reprisals at work. Says a 28-year-old weaver: "Frankly, I wish Icahn would have taken over Dan River."

By Pete Engardio in Danville, Va.

other stocks or bonds within a year. These provisions appeal especially to small companies. "We're signing up a new member every day," reports David M. Binns, managing director of the ESOP Association, a trade group. Most new members come from the hundreds of thousands of Americans who have the lion's share of their wealth locked up in enterprises with 50 to 100 people.

But the big ESOPs attract the most attention, and when used in buyouts, stand in sharp contrast to the more traditional buyout. In a conventional buyout, institutional investors often acquire half or more of the stock by providing most of the equity and debt. In an ESOP deal, the ESOP's loan replaces most of the institutional money, and management doesn't have to share as much control with institutions. A group of top managers can get 20% to 50% of the equity by investing cash and trading in existing stock options in the old company. Even if the ESOP has more than 50% of the stock, management retains control by naming a committee of directors to instruct the ESOP trustee how to vote.

ARM'S LENGTH. But some fundamental legal questions are emerging from the use of ESOPs as a buyout device. Because management, outside investors, and the ESOP all contribute funds, each should receive company stock roughly in proportion to its investment. ERISA says an ESOP must receive "adequate consideration" in the amount of stock it acquires in return for the loan. As courts have defined the term, this means the ESOP should engage in "arm's-length bargaining" to get a fair share for the employees. But the Labor Dept. has questioned in some transactions whether the ESOP trustee—who is usually a company official or a bank official appointed by management—is independent enough to achieve that.

At the center of the rising demand for ESOPs—and the rising controversy over them—is Kelso & Co. Since 1970 it has arranged financing for more than 600 ESOP-leveraged buyouts, including some of the largest and most controversial. The 71-year-old Kelso remains a partner in the firm but no longer plays an active role in the transactions. He spends most of his time, along with his wife and co-author Patricia Hetter, promoting ESOPs.

Sporting tweed suits and polka-dot bow ties, Kelso goes from podium to podium recounting how he developed his economic ideas when he was young and poor during the Depression. Now, after 25 years of "hollering in the dark," Kelso believes he is winning the respect he deserves. But Kelso & Co.'s business strategy has taken a deeply ironic turn. For years it worked mainly with small

A COMPANY WHERE EVERYBODY IS THE BOSS

Two things catch the eye of a visitor to a cable plant owned by W. L. Gore & Associates Inc. near Newark, Del. One is that the people work with great intensity, whether they operate machines that extrude brightly colored insulation for computer cables or inspect every inch of the finished cable. The second is that nobody seems to be in charge. Workers rely on their own initiative. That's largely why Gore remains as entrepreneurial as it was 27 years ago, when Chairman Wilbert L. Gore and his wife, Genevieve, now secretary-treasurer, started the business in the basement of their home.

A former chemist at Du Pont Co., Gore discovered a way to use Du Pont's Teflon polymer as an insulator for electrical cables. Today his company also uses Teflon in producing vascular grafts and the well-known Gore-tex fabrics for outdoor apparel and spacesuits. A closely held concern, Gore does not disclose revenue and earnings but says its business is growing at a 25% annual rate. Last year's sales probably approached $250 million, and the company now has 30 plants.

Some 3,000 U. S. employees—they're called "associates," in keeping with Wilbert Gore's dislike of the boss-employee relationship—own 10% of the company through an Associate Stock Ownership Plan. Gore contributes 15% of each person's annual pay to the plan and reinvests the rest of its earnings in the business. Some workers with 15 years of service have accumulated $100,000 worth of stock. Of the total $692 million in equity, 80% is owned by Gore family members and other veteran "associates" who work at Gore. Outsiders hold only 10%.

FREE TO LEARN. The atmosphere at Gore is informal, family-like. "You're free to learn as much as you want and assume responsibility and leadership," says Brian M. Linton, a group leader. Close supervision is rarely needed.

WORKERS LINTON AND BATEMAN SOLVING PROBLEMS RATHER THAN BARKING ORDERS

"Area leaders," such as Linton's father-in-law, Ralph G. Bateman, solve problems rather than bark orders. "People work harder in this type of atmosphere than when somebody stands over you with a club," he says.

To keep a friendly workplace atmosphere and ensure that everybody is treated fairly, the company limits plant size to about 200 workers. "It takes more investment to build new plants [than to expand old ones]," Wilbert Gore says, "but this is offset by the overall performance of the firm."

It is hard to find someone at Gore who doesn't like the job. "I love it," says H. Edward Smith, 24, who took a $3-an-hour pay cut to come to Gore. Says Frances Hughart, an inspector with 22 years of service: "We manage ourselves here. If you waste time, you're only wasting your own money."

By John Hoerr in Newark, Del.

companies, charged modest fees, and promoted ESOPs as a blessing for employees. Now, under Managing Director Joseph Schuchert, it is aggressively promoting ESOPs to corporate management as a means of avoiding takeovers and gaining control of company stock, while still benefiting employees. "It's a long way from Kelso's roots," observes a competing investment banker.

Kelso & Co. has formed a partnership to invest in ESOP buyouts in competition with big-time firms, such as Kohlberg Kravis Roberts & Co., that specialize in conventional LBOs. To make ESOPs appealing to managers, Kelso often puts together financial packages that offer them more stock than other buyout firms. Management's share of stock was an issue in two of the most controversial ESOP buyouts, at Raymond International and Blue Bell.

Raymond decided to go private in an ESOP-leveraged buyout in late 1983, partly because Chairman Henry F. LeMieux worried that the company might be taken over by an asset raider. Raymond called in Kelso, which had arranged the Dan River deal in early 1983, and completed an ESOP-leveraged buyout in October, 1983. The total cost of the transaction was $219 million. Of that, the ESOP—covering about 6,000 employees—furnished $100 million in the form of a 10% note to the company. Raymond, which terminated its pension plan, is repaying the note with what would have been pension contributions.

'KILLER BEES.' The company also borrowed a controversial stock plan from Dan River, involving two classes of stock. With its $100 million loan, the ESOP paid $10 per share for a Class A common stock. Kelso and 28 Raymond managers, dubbed "killer bees" by unhappy Raymond workers, bought Class B common stock for $1.09 per share with $5.4 million in cash, stock, and stock options. Raymond originally proposed that the B stock be pegged at a level always $10 under the A. If the company prospered and the A stock rose from $10 to $40, the B stock would go to $30—a thirtyfold increase for management vs. a fourfold rise for employees.

Brian M. Freeman, a financial adviser to unions and a former Treasury Dept. official, analyzed the proposed Raymond setup for the Labor Dept. Under the initial plan, he says in a report prepared for the department, the management group would have owned up to one-third of the company for a "nominal investment," compared with the ESOP's input of $100 million.

In an interview, Freeman concluded: "Management and outside investors would walk away with a disproportionate piece of the company on the upside if the company grew. It was, arguably, a transfer of wealth from the employees to the managers." At the Labor Dept.'s suggestion, Raymond reduced the managers' share to a maximum of 20%. The department now recommends that a company setting up an ESOP hire independent financial experts and lawyers to advise a plan trustee on the allocation of shares.

Kelso's Schuchert defends the Raymond and Dan River plans on the grounds that managers deserve a larger cut of the pie than employees because they risk more and because they bring special skills and knowledge to the job. "I'm comfortable giving management a premium of 20% to 25%," he says. "If we didn't give them that much, we couldn't

THE TAX INCENTIVES CONGRESS HAS HANDED TO ESOPs . . .

YEAR	LAW	INCENTIVE
1974	Employee Retirement Income Security Act (ERISA)	Gave first legal sanction for a leveraged ESOP and permitted tax deduction of both principal and interest payments on loans to ESOPs
1975	Tax Reduction Act	Created the TRASOP (Tax Reduction Act Stock Ownership Plan), allowing a tax credit of 1% of a capital investment if employer contributed that much to ESOP
1978	Regional Rail Reorganization Act Amendment	Required Conrail to contribute 15% of federal grant to an ESOP
1980	Small Business Employee Ownership Act	Permitted Small Business Administration to lend money to ESOPs
	Chrysler Loan Guarantee Act	Required Chrysler to install an ESOP as one condition of $1.4 billion loan guarantee
1981	Economic Recovery Tax Act	Phased out TRASOP and established PAYSOP (Payroll-based Stock Ownership Plan), permitting a tax credit of ½% of payroll if employer contributed that much to ESOP
1984	Deficit Reduction Act	Allowed banks to exclude from taxable income 50% of interest received on loans to ESOPs
		Permitted a tax-free rollover of proceeds from sale of a large block of stock to an ESOP if the money is reinvested in other stocks or bonds within a year
		Excluded dividends paid on stock held in ESOPs from corporate taxes
		Allowed ESOPs to assume estate taxes and spread payments over 14 years on stock transferred from estates

DATA: BW

. . . ARE PRODUCING EXPLOSIVE GROWTH

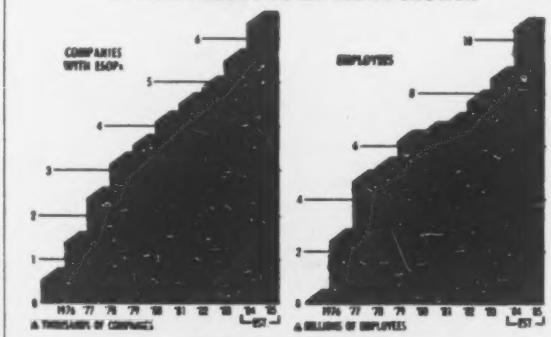


CHART BY BRIAN KEZYS/BW

do deals. Managers would opt for non-ESOP buyouts, and workers would end up with nothing." He also points out that if Raymond failed and had to sell its assets, the ESOP shares would be paid off before management's shares.

NO VOTES. But the employees have no voting power under the existing plan. It requires the ESOP trustee to vote the stock according to the instructions of an administrative committee appointed by the board of directors. In fact, employees may not vote their own stock until it is issued to them at age 65.

Since the buyout, Raymond's revenues have fallen from $1.6 billion in 1982 to barely $1 billion, largely because of a worldwide decline in major construction projects. The company has laid off almost half of the 6,000 employees covered by the ESOP. Exclaims a former Raymond engineer: "Are people working harder? No! People are pulling their heads between their shoulders and trying not to be seen." F. R. "Chip" Mason, Raymond's chief financial officer, counters that "the state of the business would have required us to take the same actions [laying people off and selling assets] if we were still a public company."

Kelso & Co. also put together an LBO for Blue Bell last November. In a highly complicated arrangement, an ESOP bought $67 million worth of the publicly traded shares—representing 33% of the new company—with the proceeds of a loan. A management group was to acquire 25%, investing $9 million in cash. The $9 million was derived partly from a $3.5 million loan by the company to the managers at below-market interest rates and partly from a paper transaction involving stock options to be repurchased by the company for cash. Outside investors, including Kelso's investment fund, were to receive the rest of the shares in return for cash, notes, and debentures.

But the Labor Dept. objected in a letter to Blue Bell that the ESOP's share of the stock was determined by the company rather than by arm's-length bargaining among the ESOP, management, and the outside investors. It concluded that "even accepting the need to provide incentives to management," the managers were "unduly enriched at the [ESOP's] expense." In the end, Blue Bell changed

THE QUESTION FOR UNIONS: WHO'S IN CHARGE HERE?

In early March the hopes for survival at Hyatt Clark Industries Inc., an employee-owned company in Clark, N. J., suffered a sharp setback. After four years of battling with union leaders, both the plant manager and the head of industrial relations resigned in exasperation. Their departure dramatizes one of the crucial labor issues that arises when a union is involved in a worker buyout of a company: How should power be divided between the union and management?

That question has strained relations at Hyatt since 1981, when the workers formed an employee stock ownership plan (ESOP) and bought the ball-bearing plant from General Motors Corp. The leaders of United Auto Workers Local 736 fought constantly with management over daily operating decisions, staff appointments and salaries, and what to do with profits.

Last April, Hyatt's board—which includes three union representatives—voted 9 to 3 against a UAW demand that profits of $600,000 be distributed to workers in a profit-sharing plan; they opted to buy new machinery instead. As a protest, workers staged an old-fashioned slowdown, helping to bring on 10 straight months of operating losses. Now, with the company struggling, Local 736 has agreed to reduce the work force through layoffs.

ANOTHER POCKET. Douglas A. Fraser, the retired UAW president who is an independent director at Hyatt, voted for the new machinery. "I said to the local guys, 'It's not that the money is going into the corporate cash register. You have got to view this as your money that goes into another pocket.' But it's hard to get that concept across."

Many union officials believe the conflicts inherent in worker ownership may never be reconciled. "There is no way workers on a meaningful basis can be managers and workers," says Lewie G. Anderson, a vice-president of the United Food & Commercial Workers (UFCW). "The interests of each group eventually clash. It just doesn't work."

But in Philadelphia, UFCW members own and operate three supermarkets

> There is no way workers on a meaningful basis can be managers and workers'

as worker cooperatives. The United Steelworkers is seeking ESOP buyouts to save failing plants. Pan Am, Western, and Eastern Air Lines are all partly owned by employees. Five UAW locals share ownership of plants through ESOPs or cooperative arrangements. Craig H. Livingston, a New Jersey lawyer who represents some UAW locals, urges unions to demand ESOPs even at healthy companies as part of "a capital strategy."

Joseph R. Blasi, who heads a research project on ESOPs at Harvard University, warns that "there is no automatic relationship between ownership and increased productivity and efficiency. This requires a well-thought-out program." His point is borne out at Pan American World Airways Inc. Workers there gave large pay cuts in return for 11% of the company's stock, but management made little commitment to improving communication with employees and involving them in solving problems. One result was the recent 29-day strike by the Transport Workers Union. At Eastern Air Lines Inc., however, worker ownership of 25% of the stock is producing revolutionary changes in labor relations and productivity.

Worker ownership is also credited with sparking remarkable improvements in productivity, absenteeism, and worker grievances at the Waterloo (Iowa) plant of Rath Packing Co. In 1979, Rath gave its 2,500 employees an eventual 60% control in return for wage concessions. But last year the company was forced to close its doors. It fell victim to high labor costs, an unfavorable cycle of hog prices, a shortage of working capital, and an aging, five-story main plant in Waterloo.

Anderson, who heads the UFCW's packinghouse division, says Rath "gave a corpse to the workers." But Lucille M. Bremer, president of Local 46, contends: "The ESOP kept the plant going for five years. We were able to employ a lot of people in that time." Although workers received worthless stock when the plant closed and the ESOP folded last December, some employees are still trying to revive the plant. They are asking former workers to chip in $4,500 each over the next three years to help raise a $10 million loan. Amazingly, 800 have signed up.

By John Hoerr in New York, with James R. Norman in Houston

the deal by dropping management's share to 21% and raising the plan's share to 37%.

ESOPs are also helping managements to insulate themselves against hostile takeovers. The tactic is simple: Put stock in the hands of employees through an ESOP, and they side with management against a takeover bid. In this event, management allows employees to instruct the trustee on voting their shares. "Employees have been extraordinarily loyal to management in takeover attempts," says Kenneth H. Miller, head of mergers and acquisitions at Merrill Lynch Capital Markets. "To get more shares in the hands of employees is an effective defensive maneuver."

A major tactic in Phillips Petroleum's long fight to avoid a takeover, first by Pickens and then by Carl C. Icahn, was to set up an ESOP and require the trustee to vote all of the stock according to employee wishes—not just the shares owned outright by the workers. In the event of a hostile tender offer, the Phillips workers probably would have voted against a takeover so they could keep their jobs. The Labor Dept. objected to the voting procedure in a letter to Phillips, but the point became moot when Phillips finally settled with Icahn without using an ESOP. The issue undoubtedly will arise again, however.

UNCHARTED WILDERNESS. Daniel R. Fischel, a professor of law at the University of Chicago who has served as an expert witness for the Labor Dept. in pension cases, says ERISA requires that the ESOP trustee put the plan's value as a pension device ahead of all other considerations in voting the stock. "It may be that the employees value their job security more than their pension rights," he says, "but ERISA doesn't cover job security."

The potential for abuse that has come to light in the large, well-publicized ESOP buyouts may be even greater at the small companies that never catch the notice of the public—or the Labor Dept. Alvin Lurie, the former IRS official, believes that most companies try to ensure that ESOP arrangements are fair. But he adds: "Where the ESOP is capable of advancing the interests of the entrepreneur, there is the chance he will favor his personal, proprietary interests at the expense of the employees."

Several questionable ESOP arrangements have already resulted in court rulings. In one of the most important, a federal court of appeals in New York last year decided that Norlin Corp. created an ESOP "solely as a tool of management self-perpetuation," to avoid a takeover. This landmark opinion held that Norlin directors breached their fiduciary duties under ERISA, which requires that an ESOP be for the "exclusive benefit" of the employees who belong to it.

The unresolved legal questions leave ESOPs in an "uncharted wilderness," as Freeman puts it. That's because the country has not really decided whether employee ownership should be embedded in the tax code as national policy. Still, enthusiasts are passionate in their conviction that employee ownership can unlock great economic powers. Norman Kurland, a Washington lawyer, onetime disciple of Louis Kelso, and the resident philosopher of ESOPs in the capital, puts it this way: "You uncover the entrepreneurial spirit in the American worker, and we're off to the second revolution." But either Congress or the courts must deal with the abuses of ESOPs before the revolution comes.

By John Hoerr in New York, with Gelvin Stevenson in New York, James R. Norman in Houston, and bureau reports

THE KELSOS: AFTER 25 YEARS OF PROMOTING ESOPs, HE FEELS HE'S GETTING SOME RESPECT

Editorials

IT'S TIME TO RESTRAIN ESOPs

The goal of turning workers into capitalists by helping them buy shares in the companies they work for has reached its fullest flower to date through a device known as the employee stock ownership plan (ESOP) (page 94). Developed by Louis O. Kelso and endowed by Congress with a rich panoply of tax benefits, the ESOP today is an idea running amok. ESOPs cost U.S. taxpayers heavily in lost taxes, $2.5 billion for fiscal 1986. That could rise to $4.4 billion by 1990. But the real danger is that the justification for all this tax largesse—and the idea's original purpose—are being supplanted. ESOPs were conceived as a credit mechanism for financing worker stock ownership. But the outbreak of takeover wars is subordinating this objective to the ESOP's new role as a defensive financing weapon, especially in facilitating leveraged buyouts. Whatever social value the ESOP might embody, it has become a tax abuse whose main beneficiaries increasingly are not workers but corporate managers, investment bankers, and outside investors. The Reagan Administration's proposal for overall tax reform would strip the ESOP of most of the preferences that make it appealing as a source of corporate financing. That is exactly what should be done.

Even in pristine form, ESOPs raise problems. Federal law says they are a type of pension fund. The overriding goal of a pension fund should be to make sure it has the resources needed to pay benefits. How many people really want their pensions tied solely to the stock of one company? Workers who own stock may be motivated to work harder, but similar incentives could be provided, with far less risk, through profit-sharing plans and other bonuses.

As ESOPs multiply, so do abuses. Workers often support them as a way to save jobs, but in many cases jobs are lost anyway. ESOPs can be set up in ways that shut workers out of decision-making and expose the ESOP to risks, while reserving potential gains for other investors.

The courts and Congress alike are beginning to wrestle with problems inherent in ESOPs. The goal should be to allow management and labor to make use of ESOPs to save companies and jobs while curbing egregious abuse. The best reform would eliminate most of the costly tax preferences altogether.

DON'T SCUTTLE AFFIRMATIVE ACTION

Reagan Administration officials can often be heard saying, "If it ain't broke, don't fix it." The Justice Dept., starting with Attorney General Edwin Meese III, should take that advice to heart in its approach to affirmative action plans that try to increase job opportunities for blacks, women, and other minorities in the work force. Meese and members of his staff attack hiring practices based on race and reject hiring "quotas." They are proselytizing other federal agenc to the point that Andrew F. Brimmer, an economic consulta and a former governor of the Federal Reserve Board, can s flatly that affirmative action "is no longer a basic policy of t federal government." Yet few business voices are calling f watering down affirmative action. For most companies it h become a routine part of personnel management. Justice ha mounted a crusade that nobody else seems ready to join.

Critics of affirmative action have always insisted that discriminates against majority job seekers, especially whit men. To some extent, they are right. But some tilt in favor c blacks and women is justified to rectify the consequences c past discrimination. Federal regulators and the courts ar available to see that the tilt does not lean too far. Only th week a federal court in Washington threw out the city's fir department promotion program as discriminatory agains whites but upheld its hiring goals that favor blacks.

Affirmative action dates back to March, 1961, and, in practical terms, it is late in the day to start tearing it down. Harol C. Fleming, president of Washington's Potomac Institute points to a new study by his organization concluding that th significant progress toward equal opportunity by minorities i due "in large part to the federal government's affirmative action program and private industry's adoption of it." Over the years business and regulators have worked out rules and procedures for affirmative action, including numerical yard sticks for sizing up progress, that both sides understand. It has worked and should be left alone.

JAPAN: NOW HEAR THIS

For weeks the Reagan Administration pointed to Apr. 1 as the date when the Japanese would reveal how much they would respond to U.S. pressure to open their big telecommunications market to American producers (page 43). That day has come and gone, and, as far as anyone can tell, the answer remains what it was: "Wait and see." Washington officials and telecommunications industry executives are coming to realize that Japan's timetable stretches far beyond that of the U.S., which calls for action right away. Because the Administration and free-trade senators and congressmen had staked so much on Apr. 1, the country now finds itself moving almost willy-nilly toward the economic retaliation that President Reagan and many members of Congress say they want to avoid. The U.S. should bend every effort to avert a mutually damaging trade conflict with Japan. But if it comes, the Japanese will have mostly themselves to blame.

The Senate Finance Committee approved a bill that requires the President to strike back within 90 days. A House bill telling the President to ban imports of Japanese telecommunications equipment failed just short of passage. Such actions are evidence more of frustration and anger than of careful thought. But they send a signal to the Japanese that the U.S. is fed up with throwing open its markets to them while being denied access to Japan's. For the good of the world trading system, the Japanese had better start moving.

Dan River Holding Company

2291 Memorial Drive
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May 23, 1985

Editor-In-Chief
Business Week
McGraw-Hill Building
1221 Avenue of the Americas
New York, New York 10020

Gentlemen:

Your recent lead article ESOPS: REVOLUTION OR RIPOFF? very substantially wrongs Dan River. In less than two years since our employee buyout over $51,500,000 of contributions to our ESOP have paid non-recourse borrowing on over 2,000,000 shares of our Holding Company's Class A Common Stock, which was shared among almost 15,000 employees and former employees. Moreover almost $2,000,000 has been paid to 1,400 of these former employees to repurchase their stock.

These contributions and payouts cost our employees nothing and very greatly exceed two years of contributions to our former pension plans. During the same period our operating company paid dividends exceeding $2,500,000 to the trust accounts of employee owners who invested its new preferred stocks and $2,100,000 for share repurchases. An additional $5,900,000 was paid to our salaried employees to repurchase their 1982 Stock Bonuses, and all employees received accelerated vesting and paid-up annuities or distributions from their pension plans. Further over $20 million in excess pension plan assets were dedicated to employees by contribution to their ESOP and hourly paid and salaried employees participating in the contributory pension plans shared refunds exceeding $4,600,000 from their portion of excess pension plan assets. Thus there have already been total contributions of over $51,500,000 to the ESOP and total distributions exceeding $17,000,000 in cash to our employee owners over and above their regular pay, group insurance and vested pension benefits. Is this withholding the wealth from the workers, a shuck and jive act, or the story of people who know they don't own anything? We think not!

While we find almost nothing in your article to agree with, I will only comment on two other aspects. First, in a leveraged buyout of a large and complex company such as Dan River the company must assure the lenders that the management

will continue to manage the business and have a deep financial commitment to its future success. In our case this was achieved by fiduciary voting control and creation of two classes of Holding Company Common Stock. 99.3% of the superior Class A Common Stock was bought at $22.50 per share with the ESOP's non-recourse promissory note and the rest was bought by Kelso Investment Associates, a third party private investor, at $22.50 cash per share. While during the acquisition payback period each share of this Class A Common Stock has a current guaranteed value of the higher of its appraised price or $22.50 plus interest in distributions from the ESOP, the actual appraised Holding Company stock values are depressed by leveraged debt. As such the Class A Common Stock held by Kelso Investment Associates has a substantially reduced value since Kelso receives no guarantee and no dividends or interest on its investment in this stock.

This same lack of guarantee applies to the Class B Common Stock of the Holding Company which was purchased by the management group and Kelso Investment Associates. As a result of the leveraging, the value of the Class B Common Stock was substantially negative when sold for cash to our key employees and our outside investment partner. That stock would have to grow almost four times the original price per share paid by the management group, or it will retain its negative value and disappear at conversion to A Stock in 1991, costing the B Stock investors 100% loss of their personal investment and giving the ESOP 100% ownership of the Company.

On the other hand if the B Stock were to appreciate in accordance with projections at the time of the employee buyout each share of B Stock would shrink to about 44% of a share of A Stock in 1991 increasing the ESOP's Company ownership to approximately 90% again at no cost to the employees. And during the intervening years while at this risk the B stockholders receive no dividends and have no voting power when their stock has a negative value. In addition the B Stock is never permitted to vote on the sale of all or a substantial part of the Holding Company assets or its merger or liquidation--this vote is controlled by the individual A Stockholders!

We believe that our employee buyout at Dan River is a once in a lifetime opportunity for our employees. Our plan was complex and called for many independent decisions and actions. However these have all been carried out and the task which remains

before us is to successfully operate our businesses in a climate which increasingly penalizes American manufacturing operations no matter by whom owned. However here again it was simply false to state that since the employee buyout the management closed four plants and closed its South Carolina headquarters. The truth is that the South Carolina headquarters were closed a year before the employee buyout and three of the four plants that this management is accused by your magazine of having closed to put workers out of jobs were actually sold as going operations to keep workers in jobs. Furthermore our employee buyout means our former employees in all four of these plants will receive guaranteed distributions from the ESOP.

Finally the federal government has enjoyed taxing our former public stockholders on the $148.9 million they received in the buyout and also taxes the millions of dollars which our employee owners have received and will receive as a result of our employee ownership program. ESOPS, a revolution-maybe, a ripoff-SURELY NOT!

Very truly yours,

David W. Johnston, Jr.

David W. Johnston, Jr.
Chairman of the Board

dc

bcc: Messrs. G. S. Elliott
M. Gitter
S. J. Hartman, Jr.
L. A. Hudson, Jr.
H. H. Huntley
W. J. Mika
J. L. Purcell
J. S. Schuchert

FOOD & ALLIED SERVICE TRADES,
Washington, DC, July 24, 1985.

Mr. J.J. PICKLE,
Chairman, Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, Washington, DC.

DEAR CHAIRMAN PICKLE: Thank you for inviting me to further comment on the implications of the tax code on mergers and acquisitions. I have limited my remarks to those areas where this department has relevant experience.

Our specific concerns are enumerated throughout this questionnaire. As you will surmise, we are primarily concerned with disclosure issues (which apply more specifically to the securities laws than to the tax laws) and the disparate tax treatment of debt and equity financing for the purposes of business combinations.

I thank you again for affording us the opportunity to present our views on this critical issue.

1. As I testified before your Committee on April 16, 1985, this department feels that the tax code does encourage mergers and acquisitions, both friendly and hostile. However, we are not of the opinion that *all* takeovers are bad. Thus, the tax code need not create insurmountable barriers to business combinations.

Specifically, we propose that the Committee consider amending the tax code such that all debt instruments (including installment debt) issued for the purposes of business combinations be subject to taxation. Secondly, we urge the Committee to recommend legislation eliminating the disparity in the tax code between the treatment of economically similar asset based acquisitions.

More narrowly, we feel the "recognition of gain and loss" should be incorporated into the corporate income tax for taxable stock acquisitions (with or without Section 338 election status), and all tax-free reorganizations. In addition we believe the current recapture laws should be tightened such that an acquired company would be required to recognize all gain or loss on property which if sold outside of the context of an acquisition would have generated income or loss.

2. Not applicable.

3. (a) Yes.

(b) It is our view that Congress should eliminate the interest deduction for all debt instruments, including installment debt, used to finance *any* and *all* mergers.

4. We feel there is a dearth of substantive information to support the notion that so-called "independent directors" act independently during hostile and/or friendly mergers. Therefore, it would be inappropriate to allow that class of directors to autonomously decide whether an unsolicited bid for control of a public company is "friendly" or "hostile".

In our view there is no need to set any standard by which hostile and friendly takeovers should be differentiated. We are concerned with impact, not motivation.

It seems equally ridiculous to amend the tax code in such a fashion that the "independent directors" of a "target" corporation should unilaterally decide the tax implications of a "raider's" unsolicited bid for control of a public corporation. We would oppose any attempt to distinguish between "friendly" and "hostile" mergers by the tax code.

5. Not applicable.

6. Not applicable.

7. The decision to repeal the interest deduction on junk bonds is largely contingent upon the definition which the Committee arrives at for those securities. Our definition of a "junk bond" is one which fails to qualify for Standard & Poor's BBB or Moody's Baa bond rating.

By this definition, it appears that there is currently an abundance of outstanding corporate paper and other debt instruments which qualify as "junk". Rather than having the Committee attempt to narrow the definition of "junk", we would support any measure to eliminate the interest deduction for all debt instruments used to finance or defend against takeovers.

8. In those takeovers which we have analyzed, the assets of the target company were used to secure the acquiring company's financing. In many cases those assets were liquidated to refinance the raider's debt costing employees their jobs and local communities substantial tax revenues. However, in reviewing this practice, we encourage the Committee to treat asset redeployment as a disclosure issue which must be resolved prior to the consummation of the transaction.

In this regard, we urge the Committee to use the acquiring company's loan agreements as the standard for "material" disclosure. The issue is not whether there is some "expectation" of asset redeployment, but whether the raider has in fact studied, valuated, and agreed to certain asset redeployments in a loan agreement when

this same information has been withheld from the raider's proxy and 13-D materials.

Public corporations are required by law to disclose material financial contracts. We believe that shareholders, employees, and effected communities have a right to review (and acquiring companies have an obligation to disclose) all loan agreements between the acquiring company and its primary lenders, and that such disclosure should be made prior to the consummation of any merger or acquisition involving a public corporation.

9. As stated in Question #7, the term "junk bond" is ambiguous and problematic and should thus be be omitted from any legislative proposal put forth by the Committee. For the purposes of mergers and acquisitions, the Committee should substitute "any debt instrument" for the term "junk bond".

10. As stated in Question #1 we feel that Section 338 encourages merger activity due to the disparate treatment of economically similar asset based acquisitions.

11. It is our opinion that the repeal of Section 338 would both decrease the number of mergers and increase the average price paid to shareholders for their stock on target corporations.

12. While this question does not specifically apply to this institution, our experience with certain takeovers has demonstrated that net operating loss carryovers are a significant inducement to would-be raiders. The tax code [specifically Section 382 and Section 269 encourage this activity. Proposed changes to these sections of the code (December 31, 1985) will only exacerbate the problem.

In particular, the proposed increase in the change of control threshold from 50 to 60 percentage points only accentuates the attractiveness of NOLS to would be raiders. Moreover, the proposed elimination of the "change in trade or business" stipulation to Section 382 in our view encourages acquiring company's to liquidate or redeploy those assets which originally qualified for the NOL tax treatment.

We urge the Committee not to delete but to strengthen the "change in business or trade activity" language of Section 382 such that a corporations net operating loss carryovers be inexorably linked to those assets which originally qualified for the NOL tax treatment. In this manner, an acquiring corporation would be required to operate the assets which received the NOL in order to continue to utilize the NOL. The transfer, sale or liquidation of any percentage of these assets would trigger the transfer, sale or liquidation of an equivalent percentage of the NOL.

13. (a) By no stretch of even the most creative imagination were ESOPs intended to entrench corporate managements.

(b) Employees who are also shareholders in their corporation often have different concerns than those shareholders who are not employed by the corporation. Asset redeployment is clearly a significant issue to employees, as are collective bargaining agreements, pension and other deferred income securities, wages, safety and health programs, and overall managerial strategy.

Because these issues are essentially unique to the employee/shareholder community, this class of stockholder must be provided with more detailed information concerning the impact of any proposed corporate reorganization on the specific issues raised above.

We feel that all shareholders and employee/shareholders in particular deserve and require the same detailed information as a corporation's primary lenders. Therefore, as we discussed in Question #8, we feel that all shareholders should be provided with all loan agreements pertinent to all mergers and acquisitions including all asset valuations and proposed redeployment schemes.

14. Not applicable.

15. It is our view that greenmail payments should be eliminated by amending the securities laws such that a public corporation would be prohibited from making partial tender offers for its shares.

16. All share repurchase programs should be treated equally under the tax laws.

17. Not applicable.

18. Acquisitions are neither good nor bad. It is the process by which acquisitions are approved or disapproved which is "bad" and by that we mean it is inadequate.

19. Not applicable.

I hope these answers assist the Committee in its formulation of proposed regulatory changes. I am confident that the Committee will propose legislation which preserves corporate democracy, while protecting the interests of employees and communities during mergers and acquisitions.

Sincerely,

ROBERT F. HARBRANT,
President.

NATIONAL-AMERICAN WHOLESALER GROCERS' ASSOCIATION,
Falls Church, VA, July 24, 1985.

Hon. J.J. PICKLE,
Chairman, Subcommittee on Oversight, U.S. House of Representatives, Washington, DC.

DEAR MR. PICKLE: Following please find answers to questions you submitted regarding the Mergers and Acquisitions hearing of April 16.

1. Yes. The Code should be neutral and not favor either the target company or the bidder. Congress should repeal Section 163 interest deduction with respect to "Junk Bond" financing of takeovers. In addition, deny the hostile bidder company from stepping-up the basis of a target company's assets for purposes of depreciation and amortization unless the step-up is recaptured and taxed. This would require amending Section 338 election and denying the availability of Section 337 treatment for liquidations in a hostile acquisition. This would help in making the Code more "neutral" so that neither the bidder or target has an unfair advantage.

2. In the wholesale food industry, stock prices are generally undervalued in relation to assets (e.g., warehouses, land, inventory and trucks). This is compounded by the fact that we have one of the highest effective tax rates in the country–approximately 40%. These two factors made one of our members, Wetterau of St. Louis, a target in a hostile takeover attempt by an oil company nearly half their size. Fortunately, Wetterau prevailed but, at great cost, in which litigation is still pending after several years.

3. Yes. See answer to question #1.

4. In order to distinguish between a hostile merger and a friendly merger certain steps need to be taken. We must put into place a process whereby outside directors and/or stockholders of *both* the bidder and the target companies would approve any particular takeover before it could be consummated. The tax Code should not make any distinction, but, should be neutral and not favor bidders over targets as it does presently.

5. N/A.

6. N/A.

7. For Junk Bonds used in any hostile acquisition. This would minimize the probability that the raider, once in control of the target company, would not sell off pieces of the new company to raise cash to pay of newly acquired debt. It is not unusual that assets are undervalued vis-a*R3-vis stock prices, thus the instant profit of a few investors supercedes the long-term value of this company to shareholders, employees, and the community.

8. See answer to question #7.

9. The best explanation of Junk Bond financing is provided by Drexel Burnham Lambert, Inc. in a recent Business Week article (March 4, 1985, Pg. 90):

"Drexel's 'Leverage' takeover works like this: The buyer sets up a new company on paper. Drexel creates a package of Junk Bonds to be issued by the paper company once it gains control through a tender offer, Then Milken (Drexel's head of its Joint Securities Trading Department) and his 125-person staff contact Junk Bond investors, seeking advance commitments to buy the bonds. Once in control, the raider can raise cash by selling off pieces of his new property. 'We take a minnow, identify a whale, then look to its assets to finance the transaction', explains Michael D. Brown, Drexel's West Coast Merger Chief."

10. See answer to question #1.

11. See answer to question #1.

12. N/A.

13. N/A.

14. In the Wetterau takeover attempt "greenmail" was paid to avoid eventual liquidation of a $2.5 billion company, which is still family operated.

15. A simple remedy to greenmail is to impose an excise tax on the receipt of greenmail similar to the excise tax passed in the Tax Reform Act of 1984 on recipients of Golden Parachute payments. This requires amending the tax Code.

16. If a company is forced to make greenmail payments, it should be fully deductible as an ordinary and necessary business expense. To be otherwise, would further skew the tax Code in favor of hostile bidder.

17. Probably not since high tech companies are R&D intensive, not asset rich.

18. No! Through friendly mergers and acquisitions, the wholesale food industry has emerged stronger and more competitive than ever. Many of our industry's recent acquisitions appear to have been made with specific goals in mind; controlling distribution costs, improving productivity, immediate access to constant technology changes, and territorial growth possible only through acquisition. The net

effect has been to strengthen our nation's independent grocers so they can compete effectively with larger companies.

An important point that should not be overlooked, is that that mergers and acquisitions in the wholesale food industry have been friendly and, in each instance, desirable resulting in a more viable and independent grocer.

The vast majority of NAWGA members are privately-held corporations. And, as in the case with many medium-sized growth companies, capital for expansion purposes can be difficult, if not impossible, to raise. Moreover, principal owners of these companies eventually find themselves with potential liquidity problems for estate tax planning. This becomes particularly acute, when family heirs have no interest in continuing the family-owned business.

Consolidation, through mergers and acquisitions, has helped our industry resolve many of these problems while improving economies of scale in physical distribution, maintaining food prices below prevailing inflation rates, and remaining the most competitive industry in the U.S., with after-tax profits less than one-percent.

19. N/A.

If I can be of further assistance, please do not hesitate to contact me.

Sincerely,

DENIS R. ZEGAR,
Vice President, Government Services.

Chairman PICKLE. The Chair would ask Mr. John Nolan, Mr. James Eustice, and Mr. Robert Rubin if they would come forward.

Mr. John Nolan, would you identify yourself? Mr. Nolan, is that you in the center?

Mr. NOLAN. Yes.

Chairman PICKLE. With Miller & Chevalier here in Washington. Mr. James Eustice who is counsel to the Phillips Petroleum Co., and a professor with New York University, and then Robert E. Rubin, a partner of Goldman, Sachs.

So, Mr. Nolan, if you will proceed?

STATEMENT OF JOHN S. NOLAN, ESQ., MILLER & CHEVALIER, WASHINGTON, DC

Mr. NOLAN. Mr. Chairman, my name is John Nolan. I'm a tax lawyer with Miller & Chevalier in Washington, DC, and I have substantial experience in corporate acquisition matters.

The current corporate merger mania, while not basically driven by tax factors, may nonetheless be encouraged somewhat by tax considerations. This occurs because we have a fundamentally defective income tax structure. Leveraged takeovers are facilitated because our tax system strongly encourages debt financing over equity investment.

Even where takeovers have been unsuccessful, the tax benefits of debt financing have encouraged defensive measures involving major new debt obligations. As a result, many prior takeover targets are now burdened by huge, dangerous debt burdens.

Furthermore, interest payments are deductible even when the underlying debt finances the ownership of stock which pays dividends far less than the carrying costs represented by that interest. As a result, the interest deduction shelters other income, tending to subsidize the acquisition.

Additionally, interest payments are deductible even when those interest payments partially represent, a repayment of principal because of inflation which cheapens the debtor's obligation and the creditor's claim. The existing tax law provides far too many benefits for debt financing.

Finally, appreciation in the value of stock is taxed at rates as low as 20 percent so long as it is held at least 6 months, while dividends and other income are taxed at rates up to 50 percent. This encourages short term, speculative acquisitions by granting an unduly generous tax treatment.

Mr. Chairman, the only real solution to these deficiencies in our tax system is fundamental tax reform. The Treasury proposals in November 1984, are a major step in the right direction, but they do not go far enough.

I participated last week in the 69th American Assembly sponsored by Columbia University at Arden House to propose an ideal tax system for the United States. Some 60 tax policy experts, including your own David Brockway and Bruce Davies debated intensely all the alternatives. The concensus was that the United States should rely upon a comprehensive base income tax with substantially lower individual and corporate rates, and with full integration of the corporate and individual taxes to eliminate the strong bias favoring debt financing.

Mr. Chairman, key features of those recommendations would affect the tax consequences of corporate acquisitions. Thus, the basis for all assets, both for depreciation and capital gains purposes, would be indexed for inflation. The investment credit would be eliminated, and only real or economic depreciation would be allowed. This would greatly decrease the importance of the increase in basis of assets that typically occurs in in a corporate acquisition.

Capital gains under these recommendations would be taxed as ordinary income after this adjustment for inflation, so long as tax rates were sufficiently reduced. Debt would also be indexed, with the result that a portion of the interest paid equal to the debtor's gain from inflation would not be deductible.

Further restrictions would be placed on the deduction of interest on debt which is effectively incurred to carry assets such as stock which do not produce currently taxable income.

But the critical element in these recommendations affecting corporate acquisitions would be the full integration of the corporate and individual tax systems so that debt financing would no longer be preferred over equity investment.

All of these fundamental reforms, taken together, would make the tax system largely neutral as to corporate acquisitions. Existing tax inducements for takeovers, mergers and acquisitions would be largely eliminated.

Mr. Chairman, this is the appropriate, permanent, correct and principled tax response to the takeover problem.

Some specific matters might be considered whether or not fundamental tax reform occurs. Further attention should be given to the deduction of interest which is incurred where the taxpayer holds investment assets, such as stock, which produce currently taxable income less than the amount of such interest expense. This should be considered both with respect to the individual tax and the corporate tax.

The equity characteristics of junk bonds should be carefully reviewed to determine whether the returns being paid on such investments are truly deductible interest rather than dividends. While greenmail payments are not deductible, there is no harm, as

Assistant Secretary Pearlman suggested, in clarifying that result in the Internal Revenue Code.

The Congress should not, however, attempt to single out hostile takeovers and deny the interest deduction selectively. And in all events, Congress should not impose an additional tax at the corporate level in a complete liquidation or deny the acquiring company the benefits of section 338. That would move in exactly the wrong direction by extending, rather than eliminating, the double taxation of corporate earnings.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF JOHN S. NOLAN, MILLER & CHEVALIER, WASHINGTON, DC

My name is John S. Nolan. I am a member of the Washington, D.C. law firm of Miller & Chevalier Chartered. I appreciate the opportunity to discuss with you certain aspects of the federal income tax system which bear on the treatment of corporate mergers and acquisitions.

Others who have appeared before you have discussed the level of merger or takeover activity which has occurred and the economic desirability of that activity. I do not intend to address those questions, which really are questions not of tax policy but rather of economics and broader public policy. Instead, I would like to focus on a fundamental feature—and problem—in our income tax system which in my judgment creates an undesirable bias in the tax system regarding the form in which mergers, acquisitions and corporate expansions generally are structured.

A basic feature of our present income tax system is that it imposes a double income tax burden on corporate profits—once at the corporate level and again at the shareholder level. The double taxation of corporate income puts a premium on a corporation obtaining capital funds by the use of debt financing rather then equity. The amounts paid for the use of debt—interest—are not subjected to double taxation because the interest is deductible from income at the corporate level. This is not true, however, if the corporation chooses to obtain needed capital funds by means of equity contributions. In this case the amounts it must pay for the use of those equity funds—dividends—are subjected to a double level of taxation. Thus, there is a bias in the present tax system toward the use of debt rather than equity for making stock or asset acquisitions, whether in a friendly or hostile context, or merely for normal corporate expansion programs. From this standpoint, the tax system is not neutral with respect to merger and acquisition activity. It encourages a corporation to utilize debt rather than equity for corporate capital needs of all types.

The use of debt in connection with recent takeover activity, both in the case of friendly and hostile acquisitions, is simply a manifestation of this bias in the federal income tax system. Without that bias, an acquirer, either a raider or a friendly investor, would not have a tax incentive to utilize debt rather than equity to effect the acquisition.

Since the present system provides an incentive for a company to use debt financing rather than equity funds for normal corporate capital purposes, one may wonder why companies do not as a general rule use a substantially greater amount of debt for all purpose. It may well be that corporate management prefers to adhere to the generally more conservative approach of retaining corporate earnings and relying on equity financing. A corporate raider, however, is not bound by, or indeed motivated by, such a policy of conservatism. The raider, therefore, can force a target company to saddle itself with a very large amount of debt either to finance the raider's acquisition or to buy off the raider. In either case, the end result is a departure from a policy of conservatism and, from an overall standpoint, is not a healthy development. The end result is an increase in debt-to-equity ratios to levels which are high by traditional standards and are basically unsound. Thus, not only is the tax system not neutral in having a bias toward debt rather than equity financing, but when that bias is combined with a viewpoint which does not have the conservatism that would constrain the maximization of the use of debt, the result is an unhealthy reliance on debt.

To eliminate or lessen the present bias which favors the use of debt for corporate acquisition as well as other purposes, various types of changes could be made in the existing tax system. The most sensible approach is to directly attack the fundamental problem—double taxation of corporate earnings—and to eliminate that double

taxation. The various means available to accomplish this goal have received full discussion over the last decade. Total integration of corporate and shareholder level taxation can be accomplished, as proposed in January 1977 in "Blueprints for Basic Tax Reform," by elimination of the corporation income tax and attribution of corporate income to shareholders through the passthrough-type treatment presently applicable to S corporations. Alternative forms of integration, which also have been the subject of extensive discussion, would retain the corporate income tax but accomplish integration of corporate level and shareholder level taxation either by allowing a corporate deduction for dividends paid or by allowing shareholders a credit for the tax paid at the corporate level. The Treasury Department's Tax Reform Proposal contained in its November 1984 Report to the President recognizes the double taxation of corporate earnings problem and embodies a proposal for partial integration. This would be accomplished under the Treasury proposal by the allowance of a 50-percent dividends paid deduction.

Although these various approaches to eliminating double taxation of corporate income differ in administrative and practical problems and conceptual basis, they all have as one of their effects the elimination of the present bias toward the use of debt rather than equity for corporate purpose. Thus, adoption of any one of these methods for full or partial integration of corporate and shareholder taxation would remove, or at least lessen, the bias toward debt both generally and in the case of hostile takeovers as well.

A more limited approach which the subcommittees may wish to consider would be to focus on the type of tax arbitrage to which the present Code § 163(d) limitation on deduction of investment interest is directed. In its present form, § 163(d) is applicable only to individuals and pass-through entities but its concern is the allowance of an interest deduction to the taxpayer with respect to debt, the proceeds of which are utilized to make investments that produce long-term capital gain or tax-exempt income. Essentially, § 163(d) limits the interest deduction allowed with respect to debt incurred for investment purposes to the amount of the taxpayer's investment income (including short-term capital gains since they are taxed as ordinary income) plus a $10,000 amount. The application of this provision could be extended to corporations as well as individuals. It then would limit a corporation's interest deduction with respect to debt which a corporation incurs or continues for investment purposes.

One of the features which appears to characterize more recent acquisitions and takeover attempts is the use of so-called "junk bonds" to obtain financing or to effect the acquisition of shares from the public. It is quite possible that even under existing law there are situations where junk bonds do not constitute debt but rather represent equity. The subcommittees may wish to consider whether junk bonds are sufficiently like debt to justify the allowance of the interest deduction—or stated conversely, whether junk bonds are sufficiently similar to stock to justify disallowance of the interest deduction. Attempts to distinguish on an overall basis between debt and equity face large hurdles as is evidenced by the difficulties experienced by Congress in developing § 385 of the Code in 1969 and by the difficulties which the Treasury Department has confronted over the years in attempting to develop implementing regulations under § 385. The subcommittees, rather than addressing this broad and difficult problem, could view the treatment of junk bonds as a discrete question which warrants action separate and apart from any broad-scale effort to delineate standards for distinguishing debt from equity. In other words the subcommittees could reach the conclusion that junk bonds are sufficiently unlike debt to justify withholding the interest deduction from amounts paid with respect to the bonds.

Finally, I would like to comment briefly on the treatment of so-called "green mail" payments. In reflecting on these payments which are made by a corporation to purchase shares of its stock held by a person attempting to take over the corporation, I find it difficult to see why the "green mail" payment does not constitute a payment in redemption of the stock. The fact that the shareholders' stock is being purchased in the context of a pending takeover attempt does not alter its fundamental nature. Accordingly, the green mail payment should constitute for federal income tax purposes a payment in redemption of stock with the normal tax consequences thereof to both the corporate payor and the recipient.

Chairman PICKLE. Thank you, Mr. Nolan.
Now, Mr. Eustice, if you will proceed.

STATEMENT OF JAMES S. EUSTICE, PROFESSOR OF LAW, NEW YORK UNIVERSITY SCHOOL OF LAW, AND COUNSEL, KRONISH, LIEB, SHAINSWIT, WEINER & HELLMAN, NEW YORK, NY

Mr. EUSTICE. Thank you, Mr. Chairman, and members of the subcommittees.

My name is James S. Eustice, I am a professor of law at New York University School of Law, where I teach various subjects specializing in Federal taxation. I have also written various books and articles on the field of corporate tax.

I also am counsel to the New York City law firm of Kronish, Lieb, which has provided legal services to Phillips Petroleum. I'm not technically counsel for Phillips Petroleum, however.

Over the past 20 or so years I have been deeply involved, I believe, in the corporate tax system. Your committee today is focusing on a selected aspect of corporate acquisitions, and there has been a lot of talk about tax policy and whether the system is working or whether the system is not working. I've always found that those that feel that the present tax system is working well are usually doing well under that system.

Some of the most succinct comments I've recently heard or read—not recently, sometime ago—were by a well-known lawyer from this area, Lou Eisenstein, in his book on "The Ideologies of Taxation," where he stated among other things that,

> Tax legislation commonly derives from private pressures for selfish ends, and that various groups are firmly persuaded that their functions are particularly vital to the progress of civilization, and that they easily reason that since their contributions are exceptional, their taxes should be small.

My own belief is that since the adoption of the 16th amendment, there has rarely been good or bad tax policy in the abstract. It is usually focused on some particular decision that Congress has been asked to make, whether it is low income housing, oil exploration, corporate acquisitions or what have you.

While the Treasury's reform proposal is a step—a huge step—toward the desideratum of total neutrality, at least my experience in the tax law has convinced me that you are highly unlikely to ever get something that is purely neutral. One person's neutrality is another person's livelihood; and that we will probably go on being forced to make decisions one way or the other as long as we have an income tax system.

We are being asked today to consider the Jones bill among others, H.R. 1100, which in part limits the interest deduction for so-called hostile acquisition indebtedness. The key problem addressed by this particular bill is a small part of a huge problem, that of attempting to draw the line between corporate debt and equity.

This particular bill is merely one small subchapter in that continuing struggle. If, as Jack Nolan pointed out, the corporate tax system were fully integrated, we wouldn't need any further tinkering with the tax law. If the deductibility of interest, however, continues at the pace it is going in some of these highly, and I emphasize the word highly, leveraged acquisitions, we may soon reach the point of de facto integration without really knowing it.

This problem is not a new one. In 1969 Congress dumped the debt definitional ball into the Treasury's lap. They writhed with it for 10 or 11 years; they tried with three versions of regulations to come up with with the perfect world. It is unlikely that we are ever going to see the perfect world here. Due to numerous protests from different portions of the tax community—I think the small business taxpayers thought it was too complicated, but the investment bankers loved it because it had bright lines which inevitably make for bright ideas—the whole thing was withdrawn several years ago for further study, and then as far as I can tell, total internment.

Surely, broader debt equity guidelines would be better. Their absence, however, does not now, nor has it ever prevented Congress from adopting a selective approach. A limited rule need not be rejected out of hand, so that the Treasury can have more time to draft regulations. I think 16 years is enough, and then show no indication of moving forward.

We could, of course, wait for fundamental tax reform. That may well be a goal which is near at hand.

On the other hand, as there always is in this area, we could wait forever for this, and in the interim all the chickens, and the eggs as well, could be gone by the time we finally get a door on the hen house.

In 1969, not only did the broad delegation to the Treasury take place, but a narrow—and virtually totally ineffective—statutory revision was also drafted, section 279. Actually this was a refinement of an initial proposal by the then Ways and Means Committee chairman, Wilbur Mills, which attempted to limit deductibility on certain forms of acquisition indebtedness.

There are a lot of ways around and out of this provision, which are all well-known, but at least section 279 was drafted in response to an equally troubling period in our history, when conglomerates were thought to be swallowing the corporate world.

Whether these provisions, and other similar provisions in the 1969 act stopped the conglomerate acquisition phase, or whether it was the decline in the stock market, or a combination of these factors, I will never know, but at least that was one instance where I think fairly narrowly targeted provisions certainly had some impact in slowing down the acquisition game.

Today's version of the acquisition game certainly has another six or seven digits attached to the numbers, but it is a very lively festival at the moment. The term junk bonds I think is maybe a bit perjorative. It seems clear to me, however, that in the egregious cases, and I am referring here to the excessively high leveraged acquisition, your traditional ownership of equity has virtually disappeared. These corporations are not only thin, they are are gaunt. The purpose of—one of the purposes of H.R. 1100—is to attempt to deny an interest deduction on certain types of debt; not for genuine debt, however, that is still perfectly allowable, the issue here is whether this is really debt, or whether it has become quasi-equity, if you will. If it is disguised equity, interest should not be deductible.

Sometimes this type of financing is called mezanine financing, in that it floats some place between the upper floors of debt and the lower floors of equity. If you look at some of these transactions,

however, I think they may have already taken the elevator down to the basement or subbasement, but it seems to me the focus of H.R. 1100, is really a narrow attempt to define something that may have gone too far or violated the ancient stock market rule of the pig theory—that you can make money being a bull and make money being a bear, but not being a pig. Many of these transactions, it seems to me, are grossly excessive or "piggish" if you will.

It can be argued, of course, why disallow an interest deduction because the interest income is taxed to the lender? In a perfect world, that is true, but in the tax world, it seems to be a fact of life that interest deduction dollars tend to come out of the 46 percent brackets and find themselves into either low or zero bracket holders. In response to my colleague, Martin Ginsburg's gracious offering of dealing with the foreign question, that may be one of the attractions of junk bonds. They find their way into the hands of foreign lenders and thus generate tax-free income to such holders. Congress in the 1984 act repealed not just withholding, but taxability on so-called portfolio indebtedness, and if these bonds get broadly enough dispersed, that may be a powerful attraction.

If they can't be broadly enough dispersed in foreign hands, there is still the Netherlands Antilles route. In other words, there is usually, if not always, a major rate arbitrage, or mismatch, between the borrower's deduction and the lender's income. As things now stand, corporate America is in danger of being turned into a great tax-exempt bond fund.

How then do you define hostile? Well, that is not easy. The Supreme Court's definition of pornography is obviously not appropriate here, but you do tend to know it when you see it. People will always be able to raise definitional ambiguities. There isn't a definition alive that can't be ambiguous. Is this the best that can be done? I'm not sure without devoting a lot more effort to thinking about it.

The other alternative, of course, which has been adopted with alacrity by recent tax legislation is a detailed and specific page-after-page definition, followed by an immense delegation to regulations, so that the rules of the game have to await regulations.

Another method, of course, is to dump the definition in the lap of another agency, such as the SEC. There is some precedent for this in the past, but it is generally not thought to have been terribly satisfactory. Or you could allow the parties to take the matter to court for a declaratory judgment, assuming we had courts with nothing else to do, which does not appear to be the case.

In short, allowing a majority of the board of independent directors, however that is defined and however much your state of cynicism as to who is independent and who is not, is not the worst that could happen here. It obviously could be tightened. Obviously you could give a zone of repentence for things that seem hostile and become friendly or the other way. The language possibilities of any definition are infinite, and it doesn't necessarily have to be a bright line.

Part of the problem today is that we have, although it does not always seem to be the case, a lot of fairly bright lines, and when people can see those lines clearly, they tend to skate as close to

them as they can, at least that has been my experience with many of our clients.

In other words, there may be some virtue in ambiguity, in restraining at least several of the medium cautious taxpayers.

In summary, we don't face a new problem here. We face an old problem. I read Marty Ginsburg's testimony. It is as always, brilliant, and of exceedingly high caliber. I agree with virtually everything he says. Moreover, I have suffered as much as most people in this room with the frequency and velocity of tax legislation.

But there may be something really serious going on out there and a recommendation for inaction, of course, is a recommendation for a form of action. In other words, doing nothing is doing something. Obviously the proposals here may not be perfect, but they could lop off a lump or two in what seems to me at least to be a somewhat unequal playing field.

Thank you.

[The prepared statement follows:]

STATEMENT OF JAMES S. EUSTICE, PROFESSOR OF LAW, NEW YORK UNIVERSITY SCHOOL OF LAW

Messrs. Chairman and Members of the Subcommittees: My name is James S. Eustice. I am a professor of law at the New York University School of Law, where I teach various subjects in the field of Federal Taxation, specializing in corporate taxation. I have also written books and articles in the field of Federal Income Taxation. I am also counsel to the New York City law firm of Kronish, Lieb, Shainswit, Weiner & Hellman. Kronish, Lieb has provided legal services to a variety of participants in the takeover process, among them Phillips Petroleum Company. Over the past twenty or so years, I have on various occasions informally advised the staffs of the Ways and Means Committee and the Senate Finance Committee, and also the Office of the Tax Legislative Counsel, primarily in the area of corporate taxation.

The Committee today focuses on certain selected aspects of corporate combinations and corporate acquisitions. In connection with that focus, I believe you have been subjected to a number of claims about what is good tax policy and what is not. It has always seemed to me that most of these claims about tax policy were made by people who had a specific objective in mind and that there is no "good tax policy" in the abstract. I have always suspected that those who claim that the current tax regime is "working well" are generally doing well themselves under that system.

Some of the most succinct statements ever made in this context were made by a distinguished Washington lawyer, the late Louis Eisenstein. In his book "The Ideologies of Taxation," he said, "Tax legislation commonly derives from private pressures exerted for selfish ends." He went on to say that, "Various groups are firmly persuaded that their functions are peculiarly vital to the progress of civilization. And so they easily reason that since their contributions are exceptional, their taxes should be small." He summed up these thoughts by stating that, "While ideologies invoke lofty abstractions, they are sensitively adapted to practical needs."

My own belief is that since the adoption of the 16th Amendment, there has rarely been "good" or "bad" tax policy in the abstract. The Congress is repeatedly called upon to make judgments about what impact the tax law should have on the economy of this country and its taxpayers—corporate and individual. For example, when Congress felt that more low income housing should be built, it provided for certain rapid depreciation methods to apply to that type of housing. When Congress wished to encourage plant modernization, it provided for an investment credit and later ACRS. When Congress wished to encourage natural resource exploration, it provided for an intangibles deduction. It is certainly fair to state that many of our current tax provisions reflect consciously adopted policy judgments by the Congress as to what activities the tax law should encourage or discourage. This has been the case since the very beginning of our tax law and I have little doubt that it will continue to be so for the foreseeable future.

You have been asked to consider H.R. 1100, which, in part, limits interest deductions on certain types of indebtedness, referred to as "Hostile Acquisition Indebtedness." One of the areas where Congress and tax experts alike have struggled mightily is where to draw a line between debt and equity. The Bill under consideration is

but another chapter in that struggle. In our tax system, interest paid on debt is deductible and can save a corporation tax dollars, whereas dividends paid on equity are not deductible. If the federal tax system for corporations were fully integrated with the tax regime for shareholders, the distinction between debt and equity might not have such importance, but in our two-tier system, the distinction has enormous significance. The importance of this distinction becomes real when debt replaces equity as the basic brick and mortar of corporate ownership. When that happens, the deductibility of interest means that roughly half of the economic burden of financing corporate ownership is shifted to the United States Treasury.

In 1969, when you enacted section 385, you asked the Treasury to draw the line between corporate debt and equity. It has failed to do so, not because it has not tried, but because the line is an exceedingly difficult one to draw. In the absence of the broader guidelines that the section 385 regulations might have provided, H.R. 1100 seeks to identify a very narrow area where a line should be drawn between debt and equity. Drawing such a line is neither "good" nor "bad" tax policy but is a legitimate response to a particular abuse situation that concerns this country and its business enterprises.

Broader debt-equity guidelines may well be desirable, but we do not have them. Their absence should not prevent Congress from identifying narrow areas of abuse and correcting them. Congress has addressed and corrected specific tax abuses in the debt-equity area before. Although a comprehensive rule might be preferred, a limited rule should not be rejected simply because it may be argued by some that the Treasury should be given more time to issue regulations. Sixteen years has already passed and we do not have those regulations.

Some will argue that narrowly targeted reform is unwise and should await the passage of broad and thoughtful reform of the corporate tax system. I myself am generally able to subscribe to that view. Like many of those here present, I have labored valiantly under the weight and velocity of recent tax law changes. But I question whether it is necessary that we must suspend all attempts to curb specific and egregious abuses of the existing law in order to await the promised land of "fundamental tax reform." We may wait forever, and find that in the interim all the chickens (and the eggs as well) are gone once we finally put a solid door on the hen house.

In 1969, your Committee acted on a type of measure similar to that which we now have before us. In response to the Treasury's request for measures that "will attack some of the basic tax problems involved in combinations and decrease the impetus toward creation of unusual security interests that are difficult for investors to evaluate," your Committee, in what became section 279 of the Code, limited the deduction for interest on certain debt securities which your Committee stated provided "a special and unwarranted inducement to mergers." In that section, your Committee disallowed the interest deduction on subordinated convertible debt issued in certain corporate acquisitions. Like section 279, the present bill is not designed to limit economic activity so much as it is designed to eliminate artificial tax inducements for merger. Other similarly inspired legislative responses in the 1969 Act included amendments to the OID rules of section 1232, tightening the installment sale rules of section 453 and modifying the stock dividend rules of section 305.

Section 279 imposed limitations on the ability of an acquiring company to issue subordinated convertible bonds that permitted the acquirer to pay for the acquisition through interest deductions. Today, the American economy faces a new type of acquisition activity—acquisitions in which vast amounts of what are commonly called "junk" bonds (that is, high-coupon, subordinated bonds which are inadequately secured by conventional standards) are issued by a group of investors (or "corporate raiders," if you will) in order to obtain control of a business enterprise. In such an acquisition, conventional equity ownership virtually disappears—to be replaced by putatively deductible-interest obligations.

The purpose of H.R. 1100, like that of the 1969 provision, is not merely to take away an interest deduction; the purpose is to deny an interest deduction for an instrument when the Congress has determined that the investment behind the instrument should be treated as an equity equivalent, not debt. This was the policy that Congress adopted in 1969 for certain types of convertible debt. Those policy considerations are equally applicable today to the "junk" bonds that are the subject of the present bill before you.

It has been argued by some that permitting an interest deduction for highly leveraged debt instruments is not necessarily bad tax policy, since the lender will be taxed on that interest. My own limited experience is that "lenders" in these transactions are often either low rate or zero rate taxpayers. As you know, under many circumstances, foreign lenders, particularly since the 1984 Act, pay no tax on the

receipt of interest income. You also know that banks and insurance companies often have very low effective rates because of certain provisions placed in the Internal Revenue Code which were designed to cushion them against financial adversity. These lenders rarely pay taxes at a rate which is as high as the rate paid by the industrial company that is the target in the transaction.

H.R. 1100 obviously is not without its problems. Some have questioned whether it is good tax policy to permit the term "hostile acquisition" to be dependent upon the actions of certain members of the Board of Directors of a corporation. There are, of course, other methods for defining a hostile acquisition. One would be to expand the proposed provision by defining such an acquisition in great detail. My own view is that that would be a futile exercise. Another method would be to permit a different governmental agency to make that decision—such as the SEC. Although there is some precedent for permitting other governmental agencies to make decisions which affect taxes, those precedents have not been very satisfactory. Another option might be to permit a court, through the device of a declaratory judgment, to make the decision, but I believe our courts are already overburdened. In short, permitting the circumstances of the transaction itself to control the application of the statute appears preferable to the alternatives suggested.

We do not here face a new problem; we face continuing abuses in an area which has long concerned the tax policymakers of this country, the distinction between debt and equity in corporate ownership. When corporate raiders are able to abuse the lack of clarity in the distinction between debt and equity, then the Congress has every right to delineate adequate boundaries to prevent such abuse.

I have read with interest the testimony of my colleague, Professor Martin D. Ginsburg, and found it to be a worthy example of his usual high caliber thought and penetrating analysis. Moreover, I subscribe heartily to most, if not virtually all, of what he started therein. On the other hand, a plea for inaction must also be weighed against the possibility that something serious may be going on in the land and it may be necessary to move quickly to stem seriously abusive manipulations of the tax law. "Inaction" as we all know, is merely one form of "action". If it is determined by this Committee to be the case, then immediate action (or even reaction if you will) may be called for and the promised land of fundamental corporate reform will simply have to wait its turn in line—it has waited for 70 years, and a few more can't hurt. In short, we live in a second best world in the tax law, maybe even a third best, depending on your point of view. It may be better to light a candle now (even a flickering and faint one at best) than curse the darkness and await the glorious sunrise. These proposals before you are not perfect, but the adoption of some of them may serve to even out some of the nastier lumps in what seems to me to be a very uneven playing field at the moment.

Chairman PICKLE. Now, Mr. Rubin, will you proceed, sir?

STATEMENT OF ROBERT E. RUBIN, PARTNER, GOLDMAN, SACHS & CO.

Mr. RUBIN. Mr. Chairman, I am Robert E. Rubin with Goldman, Sachs & Co., an investment banking firm in New York. I have been involved for the last 19 years in an activity called risk arbitrage, which is basically investment of firm capital in publicly announced mergers, corporate reorganizations, tenders, bankruptcies, any kind of a corporate reorganization.

Also, I have responsibility for things like foreign currency and commodities, but that is not relevant here.

I do not have a formal oral statement. I have a written statement, which I will submit in whatever way that is appropriate.

I have a few informal comments I would like to make, based on my experience, and I do not have expertise in taxes. One is that, as you know, there are other committees that are taking a look at this whole area of tenders. I participated with respect to one of them. I suspect that there is probably something to be said—if there is a problem—for dealing with it directly rather than via the tax law.

I was also on the SEC blue-ribbon committee to deal with this subject, and it is a very complicated and complex subject. I have the feeling it may be better dealt with directly rather than indirectly.

Second, for the last 19 years, partly with my arbitrage hat on and partly when our firm gets involved as investment banker, with my investment banking hat on, I have been involved with literally hundreds of mergers, tenders, and so forth. It is my overwhelming impression that these are not tax driven. Taxes are obviously not irrelevant to a merger or a tender, just as they would be relevant to any other kind of business decision, but I cannot think of a single instance that I have been involved with where taxes have been the determinative consideration in determining whether or not to have a merger, except perhaps where somebody has a tax loss carryforward and was trying to make an acquisition to utilize the tax loss carryforward.

The question of hostile tenders is obviously before this panel. Whether hostile tenders are good or bad for society is a judgment in which I suppose reasonable people could disagree.

My written statement, which I won't repeat here, lists a number of considerations to suggest that hostile tenders do serve a significant social purpose. I would really just like to briefly mention two.

One is the obvious one, which is that in most large companies today, managements and boards of directors are self-perpetuating. Probably the only effective countervailing power in the system is the threat of a hostile tender. Even if many hostile tenders turned out not to be economically desirable, and I don't think anybody knows—in fact, I'm sure nobody knows—whether or not most of these are desirable or undesirable, the mere threat of a hostile tender clearly is an important part of the system and creates an incentive for performance.

Second, hostile tenders are a method of reallocating resources in the society, and I think it is probably the case that in many instances companies, with respect to which tenders are conducted, are companies which do not need the totality of the resources that are under their control.

Finally, one other comment with respect to hostile tenders, well, I guess, really, tenders more generally. The question has been raised as to whether junk bonds are, in effect, really becoming another form of equity and how do you distinguish between junk bonds and equity?

At least from the point of view of the investor, it seems to me that is really not a terribly complicated question. It is true that junk bonds and many financings have taken on certain equity characteristics; but the fact still remains that for the investor, for the purchaser of a junk bond, there are enormous differences in the risks and the rewards as between junk bonds, even the lowest form of subordinated debenture, and equity.

The clearest example of this is to look at a bankruptcy. We have made substantial amounts of money at my firm, by buying the subordinated debt that exists in bankrupt companies. Generally speaking, in the reorganization, the holders of subordinated debt will recover a fairly good portion of the original face value of the debt and generally speaking, the equity holders are wiped out. Finally,

one comment on leverage buyouts. I personally believe and have felt ever since leverage buyouts first began—which is much longer ago I think than most people realize, because they initially existed in rather small companies—that leverage buyouts may in time contribute significantly to the economic health of this country. I believe that they take the management of companies and turn them into owners, and by turning them into owners, create a very different set of incentives and I would guess considerably enhance efficiency in the operations where this takes place.

I think it may well be that in time people will see the advent of leverage buyouts as having been a great reenergizing force in our economy, and a powerful offset toward the tendency of corporate bureaucracy; although I have no doubt that at least some of these companies have been substantially over-leveraged and there will, in addition to the successes, be some failures and some bankruptcies.

Thank you.

[The prepared statement follows:]

STATEMENT OF ROBERT E. RUBIN, PARTNER, GOLDMAN, SACHS & CO.

This brief written statement summarizes various thoughts which in my view are pertinent to a consideration of changing the tax laws to adversely impact mergers in general or hostile tenders in particular.

Firstly, to provide a context for my views, I am a general partner and member of the Management Committee of the New York investment banking firm, Goldman, Sachs & Co. I have been involved in risk arbitrage activity at Goldman, Sachs for nineteen years, and I am also presently responsible for risk arbitrage and various other trading activities, including options and commodities.

My overall view is that if there should be some impediment to either mergers or hostile tenders, that should be done directly rather than through the tax laws. I don't believe interest on debt involved in these activities should not be treated differently than interest incurred for other business purposes. I will restrict the rest of my comments to unfriendly offers.

Even if a view were taken that interest should be disallowed for business activity which is not socially useful, I believe for the following reasons that hostile tenders serve significant economic purposes:

1. Perhaps most importantly, the general possibility of a hostile tender is the most powerful check on the power of corporate management, since proxy fights are, in most instances, not practical. In fact, the possibility of a hostile tender is for many companies the only counterbalance in the corporate system, since management and boards are in most instances self-perpetuating. The point is not that individual hostile tenders are necessarily conducted only with respect to poorly managed companies or under managed assets, but rather that the possibility of a hostile tender causes all managements to be more concerned about performance and is for most companies the only external check and balance to absolute power by management and board.

2. The nation's economy is the world's most efficient in part because of the free reallocation of capital to the highest bidder or most efficient or innovative user. Artificial restraints upon that reallocation would impair efficiency and change, and would almost certainly have undesirable, unintended consequences.

3. Communities, unions and others may be disrupted by a successful hostile tender, just as they may be disrupted by discontinuance of a product, a UDAG grant which causes a plant to move from one locality to another, or many other economic events. I think that this concern needs to be addressed, but through creating retraining and adjustment programs rather than through creating rigidities in the economic system. Alternatively, if the potential for local disruption gives rise to restrictions on hostile tenders, should plant closings, product discontinuations and other similar corporate activities also be restricted and, if so, what would the cost of such rigidity be to our economy.

4. Restricting hostile tenders would not correct managements' concern with short term performance to any significant degree, because this is primarily a function of many other factors, including the short term perspective of institutions. I might add

that that short term perspective of institutions is largely due to the short term performance pressure generated by the corporate pension clients, who then complain about the short term perspective of institutions.

5. A restriction on hostile tenders is an abridgement of stockholders' property rights and could be a precedent for additional abridgements. This concern might have an additional depressing effect on equity prices.

6. The contention that tender offers distort the credit markets and effect interest rates does not seem to withstand analysis.

7. Finally, and I think very importantly, our system has been based on the notion that the primary duty of corporate directors and officers is to their stockholders. If that is to be changed, all of the ramifications of such a change should be thought through with great care. I would guess that many of the proponents of restrictions on hostile tenders—especially those in corporate management—would be greatly troubled by the places this thrust tends to lead e.g. regulation on behalf of many so-called public interests.

In sum, though some hostile tenders will almost surely be economically undesirable, and some may be disruptive, I believe these costs are greatly exceeded by the substantial benefits of not restricting hostile tenders. I also feel that this whole area of hostile tenders gives rise to simplistic statements and analysis regarding highly complicated issues that are fundamental to our economic system.

As one final note, I believe strongly that in time the leveraged buy-out phenomenon will contribute substantially to the functioning of our economy. Undoubtedly, there will be leveraged buy-outs that are ill conceived and even in some cases become insolvent. On the other hand, leveraged buy-outs put managers in the position of owners, and so create far greater incentives for performance and efficiency. Leveraged buy-outs may be a great re-energizing force in our economy, and a powerful antidote for corporate bureaucracy.

Chairman PICKLE. Thank you, Mr. Rubin.

I thank all of you gentlemen for your testimony. This has been a rather long hearing and I imagine that you have been worn out while all the other witnesses have been presenting their testimony. We are sorry these things stretch out this much, but we wanted to get all the testimony on the record.

Now, Mr. Nolan, and Professor Eustice, do I understand you to say that the best thing we could do if we wanted to put a stop to these kinds of takeovers, the hostile takeovers, would be just to pass a new tax bill, a simplified Tax Code that would do away with all of these incentives, the tax credits and deductions.

Mr. NOLAN. What I was saying is that the best long term solution, in fact, the only permanent solution as I see it, is to move forward on comprehensive tax reform.

Chairman PICKLE. Along the lines that have been proposed?

Mr. NOLAN. Further than the lines that have been proposed.

Chairman PICKLE. How could you go further?

Mr. NOLAN. Well, there are a number of ways in which you can go further, but basically the provisions——

Chairman PICKLE. I'm listening.

Mr. NOLAN. Basically the provisions that would affect takeovers are incorporated in the Treasury proposals, so if you go as far as the Treasury proposals go, then you will, as I see it, make the tax laws largely neutral in this area.

Chairman PICKLE. If you take away the ITC's stepped up basis, capital gains, and put in indexing, you sure would go along way, wouldn't you?

Mr. NOLAN You take away the ITC and take away the accelerated depreciation and substitute for that inflation adjusted basis. You don't take away the basis. That's not part of these proposals.

Chairman PICKLE. I see. Professor Eustice, will you try to disagree with that, or are you in general agreement?

Mr. EUSTICE. I can agree with that. Another route, of course, is full corporate integration, which is not proposed by the Treasury, it is only partial integration. There it would have been totally immaterial whether you had debt or equity.

Mr. NOLAN. I should have made it clear that that was in one of the respect that I think you must go beyond the Treasury proposals, because I am a strong proponent of full integration of the corporate and individual tax.

Chairman PICKLE. If we were to take this route, do you think corporate America could go from this system next year into the new system?

Mr. NOLAN. Well, I think——

Chairman PICKLE. Without exploding?

Mr. NOLAN. Well, I think it will take some transition rules. I think that the transition has to be steady, but transition is essential, but I don't think there is any permanent problem. I think that corporate America is going to be much better off in the long run with the comprehensive income tax base system, then it is under existing law.

Chairman PICKLE. Well, that's a challenge we may be faced with starting in about 2 or 3 weeks. Be anxious to see how we work it out.

In the meantime, do you take the position that we don't need to do anything in these acquisition areas?

Mr. NOLAN. No; I made some specific suggestions. I do not favor personally focusing on hostile takeovers. I see no basis from a tax standpoint of distinguishing between types of takeovers, but I do think there are things that need attention.

I have suggested that the provisions that deal with interest which is incurred to carry assets which do not produce currently taxable income equal to that interest ought to be reexamined. We have a provision like that, 163(d), that affects individuals only. It is not very effective. There are no regulations under it. I do not know why it should not be equally applicable in appropriate circumstances to the corporate tax. I certainly think we ought to look at that.

I think that the whole issue of junk bonds needs further attention, because I am not sure that the returns on those bonds are clearly interest from the standpoint of the tax system.

Chairman PICKLE. Would we be doing enough if we simply had an effective way to have shareholders vote on this question of takeovers?

Mr. NOLAN. That's beyond my expertise. I don't think I can answer that question.

Mr. EUSTICE. I second that, but there is another route you could go here and you started that route in 1984 on limiting the intercorporate dividends received deduction on leveraged portfolio debt, which, of course, does not cover these acquisition transactions.

If you went down that road, you would simply drop the word portfolio and would, in effect, match your interest with your dividends received deduction. That would be another possible technical route.

Chairman PICKLE. Mr. Flippo.

Mr. FLIPPO. Thank you very much. Thank you for your testimony.

Mr. Eustice, we have talked some today about trying to limit junk bonds and trying to say that any financial institution with deposits guaranteed or insured by the Federal Government should not possess junk bonds.

You as a craftsman, would you have any difficulty in moving around that definition of junk bond in terms of adding another wrinkle or two to it?

Mr. EUSTICE. The present definition?

Mr. FLIPPO. Yes, sir.

Mr. EUSTICE. I'd have to think about it a while, but I'm sure people would try. Whether they would succeed or not is another matter.

Mr. FLIPPO. Well, it's amazing the creativity.

Mr. EUSTICE. That's true.

Mr. FLIPPO. Mr. Rubin, I'm very interested in trying to find out what the role of the arbitrager is in all of this. It is said that when someone puts a company in place, that it is doomed. What do they mean by that? What role does the arbitrage operations play?

It seems to me that you only make money if the deal goes through, if a merger and acquisition is, in fact, effective. Are you the reason we are having them? What role do you play in that? But if you don't buy into it, does it go?

Mr. RUBIN. No, I think what arbitrage people basically do, as you probably know, is after something has been—I don't know how this relates to the tax law exactly—but after something is publicly announced, then a stock rises in price to reflect whatever it is that has been announced.

On the bid side of the market, the buyers of all the stock at a price that reflects whatever has been announced, are the arbitragers, people like ourselves. What we are basically doing is buying stock from people who have decided that they would rather cash in a price that reflects what has been announced than remain long term stockholders of the company for whatever may happen.

So even though we accumulate stock that has come into the market, I think it is almost surely true that in almost every situation, if we didn't buy it, that same stock would support a corporate transaction, whether it be a hostile tender or merger or whatever.

Mr. FLIPPO. Is that why they are said to be doomed once one is put into play that they will be acquired by someone?

Mr. RUBIN. I think that the reason people seem to—I really think that for the purposes of whether or not something happens, we ordinarily tend to be relatively irrelevant.

I think the view that once something has been put into play, it is generally doomed, is not because of our existence. It is true that to the extent that arbitragors buy stock, they absolutely are committed to wanting a deal, but the people they buy it from have decided they want to turn their stock in for cash anyway, rather than remain long term stockholders.

I think the reason people say a company is doomed once it is put into play is that once somebody has started to create the possibility of a much higher price than the market was providing, stockholders simply want to have a higher price.

Mr. FLIPPO. You said you worked with investment banking, too.

Mr. RUBIN. Yes.

Mr. FLIPPO. How do they identify their targets? I asked an earlier witness. Do people have a computer program where they develop a tax profile for a company and then they run through the 10 k's? Where do you get the information? Do you run through 10 k's and get a match?

Mr. RUBIN. I would say every full fledged investment bank from the street today has all kinds of sophisticated computer runs and computer screens and that is true of the kind of people who are interested in making these kinds of acquisitions as well. They don't look for tax characteristics. They look to satisfy whatever kind of business criteria they have.

Mr. FLIPPO. They do not necessarily look to the tax you said, I believe?

Mr. RUBIN. It's not taxes. You know, to say the interest is deductible, it is obviously relevant to structure your deal, but that isn't what enters into the decisionmaking process, no.

Mr. FLIPPO. I thank the gentleman for his testimony and I thank the Chair.

Chairman PICKLE. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Do we have somewhat of a concensus on this panel that, in a perfect world, this committee would not be the place to solve this kind of problem? I know Mr. Rubin said that, and another gentleman sort of leaned that way, but didn't say it specifically.

Mr. NOLAN. Well, I can speak for myself on that and say that I think that this is not a tax problem basically and that I see the solution only being a permanent wholesale revision of the income tax structure.

Mr. SCHULZE. Mr. Eustice?

Mr. EUSTICE. I don't go quite that far. I think there are pieces of the legislation that do relate to tax problems. I think the Five-Star issue, or the deductibility question, is a tax problem. I don't think it needs a statute, but you can certainly draft a one sentence statute that everybody can understand.

I think the greenmail problem is a securities problem, not a tax problem. Overleverage I think is a tax problem, or as much a tax problem as any other problem, and whether these transactions are driven by the tax law or not, I am in no way to say, but you don't see them being done with preferred stock. You see them being done with debt, and my natural instinct is to say they are being done that way not because people enjoy being debtors, but because it does something for you. Tax law may not be the engine here, but it is certainly the steering wheel that dictates transactional form.

Mr. SCHULZE. That leads to my next question, and that is is this an American phenomena? I guess this panel is probably as well equipped to answer that question as any before us. Is this happening in other parts of the world?

Mr. EUSTICE. I have no knowledge of that at all.

Mr. NOLAN. Neither do I.

Mr. RUBIN. I don't have extensive knowledge, but there have been a goodly number of unfriendly takeovers in Great Britain.

There have been a fair number in Canada, and beyond that I don't know.

Mr. SCHULZE. Do any of you gentlemen know of any laws in free world countries that prohibit this type of acquisition?

Mr. RUBIN. Well, Great Britain has a control—well, control isn't quite the right word—they have requirements so that if you go for part of the company, there is no prohibition against a hostile tender, but they have two things. They have a requirement that if you go for part of it, you have to go for all of it, and they also have a public policy review process unlike anything we have here.

Mr. SCHULZE. Thank you, gentlemen.

Chairman PICKLE. Mr. McGrath. Mr. Flippo.

Mr. FLIPPO. Yes, Mr. Chairman, I did have one other question I'd like to ask Mr. Rubin. The profits that are made in your area——

Mr. RUBIN. We have losses as well, but go ahead.

Mr. FLIPPO. Well, that's very interesting. You pay tax on those at ordinary rates or capital gains rates generally?

Mr. RUBIN. Virtually all the profits in our area are short-term capital gains, so that we would ordinarily pay taxes at short-term capital gains rates unless for some reason or other they wind up being turned into long-term capital gains.

Mr. FLIPPO. Generally you get in and out in less than 6 months.

Mr. RUBIN. Yes, ordinarily.

Mr. FLIPPO. Are you aware of any instances in which those transaction—can they be structured to produce capital gains?

Mr. RUBIN. You mean long-term capital gains?

Mr. FLIPPO. Yes.

Mr. RUBIN. If the corporate reorganization itself takes less than 6 months, then ordinarily it is going to result in a short-term capital gain.

If it is a tax free transaction, stock for stock, then there is a way of taking that short-term capital gain and so-called aging it and turning it into a long-term capital gain.

Mr. FLIPPO. Thank you very much.

Chairman PICKLE. Mr. Rubin, I didn't ask you a minute ago—do you share the same feeling with Mr. Nolan and Professor Eustice that we ought to have this integration of the system? Would that be a better answer?

Mr. RUBIN. Mr. Chairman, I am really not expert enough to respond to that, nor is—you mean an integration of individual and corporate income taxes?

Chairman PICKLE. Yes.

Mr. RUBIN. That is not something I've thought enough about to have an opinion.

Chairman PICKLE. You hesitate to get in that ball game as Mr. Nolan didn't want to get into the issuing concerning shareholders.

Let me ask you because I assume what you are interested in is the money, that part of it. Goldman, Sachs is innocent money and you don't have——

Mr. RUBIN. We serve an economic function.

Chairman PICKLE. You just got in the game to make a little money and not much, but just a little piece. You hope you don't get hurt, but every now and then you might get hurt a little, but you roll the dice and hope you do all right.

That's essentially what you do though?

Mr. RUBIN. I would say you have got a pretty good sense of our business.

Chairman PICKLE. Well, all three of you, suppose we get into the area of shareholders, I asked the question a minute ago: What if we just left it to the shareholders to decide whether to be acquired or merged?

The temptation may be to say if I get the high price, I'll vote to merge, and that might be their approach; but they also might take into consideration, that company is going to have a lot of new debt, be worth more, but owe more. So they may not agree. You don't know what to do on it.

So what could the shareholders do to prevent a takeover using the tax laws? Is there anything they could do using the tax law that comes to your mind?

Or if not the tax laws, what about the security laws?

Mr. RUBIN. What could the shareholders do, Mr. Chairman?

Chairman PICKLE. Yes, the shareholders. I'm not trying to keep the tax laws so somebody can make a lot of money. Some of them are making a potful of it. Now, we are trying to see what can the shareholder do who had invested in this company which has become a target. Can they do anything that you gentlemen can think of?

Mr. NOLAN. Well, they can certainly write to all the other shareholders and tell them this company is worth a lot more than they are offering us and we ought not to sell our stock, and if they can make a strong enough case for it, persuade the other shareholders, then they can——

Chairman PICKLE. How to do that would be another matter I don't know how they could do it, but that's a possibility.

Mr. EUSTICE. That's not using the tax law, that's using argument or persuasion. I can't think of anything they could do under the tax law that would help.

Mr. RUBIN. Maybe I'm missing—I may not recollect everything that has transpired, but I can't think of any situation offhand involving a large company and a large situation where the shareholders were opposed to being acquired. It's usually management or the board.

Chairman PICKLE. Well, it just seemed to me that at some point it might be well to get the shareholders to express themselves.

Of course, they may have a right ultimately, but before the action is made final or either at some stage of our consideration, it might be that we are going to get some expressions that they have to endorse and they have to approve. That's another approach, too, and we don't have one at this point—did you have another question?

Mr. FLIPPO. Yes; Mr. Chairman, since this is our last witnesses I believe for the hearing and I believe Mr. Nolan has advanced a suggestion in regard to 163 that we haven't had before. I wonder if Mr. Eustice would care to comment on applying that limitation in 163 to the corporate.

Mr. EUSTICE. There is no reason not to do that and it is less drastic than the Jones bill. It would simply confine, in effect, adopt a schedular system for acquisition debt. It's done—well, it's been

done already for leveraged portfolio acquisitions, but there is precedent for it.

Mr. FLIPPO. So the definitions are already there? The precedents are already set?

Mr. EUSTICE. Acquisition debt in 279, too. You could fix that very easily. The definitions are there, and it is a question of what you want to do, how far you want to go.

Mr. FLIPPO. And do you believe that would effectively deal with the merger problem?

Mr. EUSTICE. No, I don't know any more than anybody else whether it would effectively deal with it. But, it would affect it.

Mr. NOLAN. I want to concur with that. I think it is a subject that ought to be considered, because it is a better approach to me than trying to distinguish between hostile takeovers and other takeovers, but I certainly don't want to leave you with the impression that that is an assured solution to this problem. It isn't.

The only assured solution is a fundamental reform of the tax system.

[The following was subsequently received:]

COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC, May 13, 1985.

Mr. JOHN S. NOLAN,
Miller & Chevalier, Metropolitan Square, Washington, DC.

Messrs. NOLAN, EUSTICE, AND RUBIN: Thank you for appearing as a witness at the Subcommittee's hearing on mergers and acquisitions. Your experience and expertise provided the Subcommittee with much valuable analysis and information. For the purpose of completing the Subcommittee's hearing record, I have enclosed a series of additional questions for your response.

I would appreciate your review and response to my office by May 24, 1985. If you have any questions, please contact Bill Cunningham of the Subcommittee staff at 225-5522.

Sincerely yours,

J.J. PICKLE,
Chairman, Subcommittee on Oversight.

Enclosures.

1. Do you feel that the tax laws encourage mergers? If so, which provisions are primarily used by the parties involved in mergers? Should the tax code be neutral toward mergers? If yes, which provisions of the tax code should be changed and how?

2. Some experts argue that a firm is vulnerable to a takeover when (1) stock is undervalued in relation to its underlying assets; (2) the corporation has a high effective tax rate; or (3) the corporation has substantial liquid assets, including an overfunded pension plan. Do you agree? What other characteristics of a corporation make it an attractive takeover target?

3. Some experts argue that the tax laws encourage debt financing rather than equity financing since corporations are allowed deductions for interest payments but not for payment of dividends.

(a) Do you agree?

(b) Should the Congress restrict or eliminate the deductibility of interest (1) generally; (2) in all mergers; (3) in "hostile takeovers"; or (4) for "junk bonds"? Please explain.

4. If a line were to be drawn for tax purposes between friendly mergers and hostile mergers, how should hostile be defined? Should a vote by the "independent directors" of the target corporation be determinative? If not, what test or standard should we use? Should the tax code distinguish between hostile and friendly mergers?

5. If the deduction for interest payments on junk bonds were denied, do you feel that such denial should apply:

(a) To all junk bonds;

(b) To junk bonds used in connection with any merger or acquisition;

(c) To junk bonds used in connection with any large merger or acquisition;
(d) To junk bonds used by any target company to repurchase its own stock.
Please explain your answer.

6. How would you define a "junk bond" for tax code purposes? Are there other debt or equity instruments with similar characteristics to those of junk bonds that we should be concerned about in evaluating the deductibility of interest?

7. Does the election under Section 338 of the Internal Revenue Code to step up the basis of assets cause mergers to happen or does it instead influence the form of the merger?

8. What impact would a repeal of the Section 338 election have on mergers? Would it decrease the number of mergers and/or affect the terms of some mergers such as pricing?

9. Do you feel that any changes should be made to Section 336, Section 337 or Section 338 of the Code? If so, what would you recommend?

10. Some experts argue that certain mergers are driven by profitable corporations seeking to offset their income by acquiring firms with net operating losses. Should the Congress address as a priority modification of Section 382 of the Code? If so, what recommendations do you have?

11. Should greenmail payments be prohibited or penalized? If so, should such regulation be done through the securities laws and/or the tax laws? Do you have any recommendations fork regulating greenmail payments through the tax code? How would you define "greenmail"?

12. Should corporations making greenmail payments be allowed to deduct those payments in whole or in part as ordinary and necessary business expenses?

MILLER & CHEVALIER,
Washington, DC, May 20, 1985.

Hon. J.J. PICKLE,
Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. PICKLE: My responses to the questions enclosed with your letter of May 13, 1985, are as follows:

1. Yes, although tax considerations are not the major factor inducing a merger and may be of little importance in most cases. The tax consideration most utilized is the ability to create debt and deduct interest in acquiring a conservatively-managed company that has sought to hold down its debt to equity ratio. The acquiring company, motivated by shorter-term profit considerations, will often be willing to increase the company's risk of economic downturns by a leveraged buy-out.

The tax law is already "neutral" toward mergers. Interest on debt is necessarily deductible in an income tax system since it is a cost of earning income. The deduction for interest may properly be denied or capitalized where the debt directly or indirectly finances the ownership of assets the returns from which are not currently taxable (for example, as in § 163(d) or § 265(2), or better still, as in Treasury I tax reform proposals). If, however, the tax preference granted to such assets is strong enough (for example, a principal residence, or the investment credit or ACRs for business assets), denial or capitalization of the deduction is not an appropriate response. See the enclosed paper on the subject of interest arbitrage.

The step-up in basis of assets in a § 337 or § 338 transaction does not contravene the "neutrality" of the tax system as to mergers. As a matter of tax policy, the corporate and individual tax structures should be integrated. See the enclosed report of the Sixty-Ninth American Assembly. It is economically and logically unsound to impose a double tax on corporate earnings, as where they are taxed to the shareholders on distribution, whether by dividends or in liquidation. In a liquidation, the retained earnings will be taxed to the shareholders, or will have been taxed to prior shareholders when they sold their stock to current shareholders. While taxed as capital gain, this represents a deliberate policy to reduce the tax rate to compensate for inflation and provide for rough averaging in a progressive rate structure. If this policy is unsound, it should be changed; a double tax should not be imposed on income from capital earned through the legal fiction of a corporation. Sections 337 and 338 serve to prevent double taxation of corporate earnings in a complete liquidation and are entirely sound as a matter of policy. See my article (enclosed) on the General Utilities principle.

2. Yes. Unused operating losses, investment tax credits, or other carryovers that can be used by the acquiring company under § 382. Similarly, if the acquiring company has large unused carryovers, it is induced to acquire a company with substantial taxable income and a high effective tax rate (your case (2)) to utilize these carryovers. No steps should be taken to interfere with this process as to net operating

losses; instead, § 382 should be repealed as to such losses. Shareholders of a corporation that has suffered losses should be allowed to achieve a deduction of those losses directly or indirectly by selling their company or by acquiring a profitable company and utilizing them. This is appropriate for the fair and efficient operation of an income tax system which must rely on an annual accounting period; averaging of income and losses is proper. As to the investment credit, other considerations exist. The validity of the credit as a preference must be evaluated. If it is not justified, it should be repealed. If it is justified, to whatever degree, it should be made a refundable credit so as to eliminate the need for carryovers. If a subsidy for business investment through the income tax system is appropriate, it should be allowed regardless of the taxable income position of the taxpayer.

3.(a) Yes. The problem, however, is not in the interest deduction but is rather in the double taxation of corporate earnings. Deduction of dividends is one way to resolve this problem. See 1, above.

(b) No—not in any case, except that if the double taxation of corporate earnings is not more fully addressed than it is in present law, interest on "junk" bonds should not be deductible where it in reality represents a disguised return on equity investment, *i.e.*, where such bonds are not true debt because of their equity characteristics.

4. No such line should be drawn. The tax law has no proper role in punishing "hostile" take-overs as compared to other take-overs. The tax law can serve a useful regulatory as opposed to revenue-raising function only in certain broad areas, such as the treatment of pensions and private foundations. Narrower regulatory-inspired efforts such as § 999 (international boycotts) are poorly conceived, do not work well, and are better accomplished by direct regulation (Commerce Department boycott regulatives). The penalty is not properly related to the conduct sought to be inhibited. There is no proper way to define a "hostile" take-over, and to try to do so in the tax code would be unsound. It would create serious administrative problems for the IRS and encourage other such regulatory efforts, undermining tax administration generally.

5. Only to junk bonds that are equity investments rather than debt. See 3(b) above.

6. See the aborted § 385 regulations, particularly § 1.385-5.

7. See 1, above.

8. It would force acquisitions into the mold of § 337, or liquidations into publicly-held limited partnerships, which would sell the assets several years later, or other artificial forms. It would decrease the number of mergers, a result that should not be achieved. Mergers may serve sound business purposes. Appropriate restrictions on mergers, if any, should be developed outside the tax structure.

9. No, but see 12, below.

10. Yes. Congress should seek to implement a sounder tax policy as to net operating losses. See 2, above.

11. Yes, but not through the tax system.

12. No. They are not deductible under existing law and should not be. They represent preferential distributions to shareholders. The proper goal to be served in this area is an integrated corporate and individual tax. One way to achieve this would be to tax all gains at the corporate level and allow a deduction for all distributions, including liquidating distributions. See 1 above and the enclosed Report of the Sixty-Ninth American Assembly.

Sincerely,

JOHN S. NOLAN.

Enclosures.

REFORMING AND SIMPLIFYING THE FEDERAL TAX SYSTEM

THE SIXTY-NINTH AMERICAN ASSEMBLY
APRIL 11-14, 1985
ARDEN HOUSE, HARRIMAN, NEW YORK

The American Assembly
Columbia University

PREFACE

On April 11, 1985, fifty-nine men and women from the federal government, Congress, state and local governments, the law, business, universities, trade unions, consumer groups, not-for-profit organizations, and the media gathered at Arden House in Harriman, New York, for the Sixty-ninth American Assembly, entitled *Reforming and Simplifying the Federal Tax System.* For three days, the participants discussed the nature of the tax system and its incidence, business and investment taxation, various proposals for tax reform, and the relationship of taxation to the federal deficit.

Dr. Joseph A. Pechman of The Brookings Institution acted as director for this Assembly program and supervised the preparation of papers used as background reading by the participants. Authors and titles of these papers, which will be compiled and published as a Prentice-Hall book entitled *The Promise of Tax Reform,* are:

Joseph A. Pechman	*Introduction*
Richard Goode	*Overview of the U.S. Tax System*
Alvin C. Warren, Jr.	*The Individual Income Tax*
Alan J. Auerbach	*The Corporation Income Tax*
Irwin Friend	*Effects of Taxation on Financial Markets*
Joseph E. Stiglitz	*The Consumption-Expenditure Tax*
George F. Break	*The Value-Added Tax*
Michael J. Graetz	*The Estate Tax: Whither or Wither*
Emil M. Sunley	*Alternatives for Tax Restructuring and Increased Revenue*

Speakers during the Assembly were Assistant Secretary of the Treasury Ronald A. Pearlman; Dr. Norman J. Ornstein of the American Enterprise Institute; and the Honorable Charls E. Walker of Charls E. Walker Associates, formerly deputy secretary of the treasury.

Following their discussions, the participants produced this report on April 14, 1985; it contains both assessments and recommendations. We gratefully acknowledge the contributions of the Alfred P. Sloan Foundation and the William and Flora Hewlett Foundation, which helped fund this undertaking. They, as well as The American Assembly, take no official stand on subjects that they present for public discussion. In addition, it should be noted that the participants spoke for themselves rather than for the institutions with which they are affiliated.

William H. Sullivan
President
The American Assembly

FINAL REPORT
of the
SIXTY-NINTH AMERICAN ASSEMBLY

At the close of their discussions the participants in the Sixty-ninth American Assembly, on *Reforming and Simplifying the Federal Tax System*, at Arden House, Harriman, New York, April 11-14, 1985, reviewed as a group the following statement. This statement represents general agreement; however, no one was asked to sign it. Furthermore, it should not be assumed that every participant subscribes to every recommendation.

THE PROMISE OF TAX REFORM

The federal tax system is widely regarded as unfair, excessively complicated, and inefficient. The general perception is that the system favors wealthy taxpayers and large business firms at the expense of the average taxpayer. Too often people pay widely different taxes even though they have the same income. The public is demanding tax reform to improve the distribution of tax burdens, simplify the tax structure, and eliminate tax distortions in the economy.

A number of tax reform proposals are now being advanced to achieve these objectives. Although they differ in essential details, all would broaden the tax base and use the revenue to reduce tax rates for individuals and corporations. Most plans would increase personal exemptions and the standard deduction to relieve families and individuals with incomes below the poverty line from paying tax. Otherwise, the distribution of tax burdens of individuals would remain roughly the same as it is under present law. A major feature of the proposals is a reduction in the wide differences in taxes paid by people in essentially the same economic circumstances. Some plans address the proper role of taxation of corporations in relation to the taxation of individuals.

The tax system has been used to achieve numerous social and economic objectives, many of which are laudable. But the proliferation of deductions, exclusions, and tax credits has gone too far. A simple tax system with lower tax rates would improve equity and economic efficiency. Nevertheless, the far-reaching changes now being contemplated would have major consequences for important groups in our society and for the economy as a whole. Tax reform legislation must be carefully crafted to avoid unnecessary economic disruptions and individual hardships.

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WHAT SHOULD BE TAXED

Some people believe that many problems now encountered under the income tax can be avoided by substituting a progressive tax on consumption expenditures for the tax on income. An expenditure tax would not distort individual decisions to consume or to save and would be free of many problems now encountered in measuring income from capital.

Because it exempts saving, an expenditure tax is roughly equivalent to a tax on labor income and might not be regarded as equitable by the public. The expenditure tax would increase the tax burdens of young families and the elderly and reduce the taxes of families headed by those in their middle years who save more. Moreover, the problems of transition from an income tax to an expenditure tax would be extremely difficult. Special rules would have to be adopted to avoid taxing those who consume out of previously taxed income.

For these reasons, we recommend that the federal government continue to rely on income taxation as the basic revenue source. However, income is difficult to measure accurately, and a number of critical problems of implementing an income tax not addressed properly under existing laws must be resolved. These include adjustment of the tax base for inflation, measurement of depreciation, treatment of capital gains and losses, and taxation of corporate profits at both the individual and corporate levels. We address these questions later in this statement.

An alternative method of taxing consumption would be to adopt a value-added tax, which is often proposed as a supplement to the income tax. The value-added tax is equivalent to a sales tax, except that the sales tax is levied only at the retail level while the value-added tax is collected as goods move through the system of production and distribution. The advantages of the value-added tax are that it can raise large amounts of revenue and that, in its pure form, it is neutral toward different kinds of business and consumer choices.

The major objection to the value-added tax is its regressivity; that is, it takes a larger percentage of income from those with lower incomes than from those with higher incomes. The regressivity of the tax can be addressed by exempting necessities, such as food and medicine, or by providing a refundable credit against income tax for those at the lower end of the income scale. Suitable exemptions could substantially reduce regressivity, and such a credit could make a value-added tax progressive up to a moderately high income level, but regressive beyond that. However, exemptions and credits would greatly complicate the tax and raise the cost of administration and compliance. The value-added tax could also result in at least a one-time increase in prices and might exacerbate the problem of con-

taining inflation, although this effect could be mitigated if cost-of-living adjustments in wage and other contracts were required to be based on price indexes that excluded the effect of the value-added tax. We conclude that the value-added tax should be considered only as a last resort if it is necessary to raise a substantial amount of additional revenue.

Estate and gift taxes account for less than 1 percent of internal revenue collections. They are, nevertheless, an important component of a progressive tax system and should be retained and strengthened to the extent that this can be done without creating undue hardships for such groups as farmers and family-owned businesses. The taxation of gifts and bequests would be critical if a consumption expenditure tax were adopted. Otherwise, the exemption of saving from tax could lead to an increasing concentration of wealth. The estate and gift taxes now being levied should be improved or restructured, even though they cannot be expected to yield large amounts of revenue.

TAXATION OF BUSINESS AND INVESTMENT INCOME

The present tax system provides generous depreciation allowances and investment tax credits for most capital investments. These provisions encourage investment, but in their present form they have made tax burdens highly uneven among industries—in some cases, this "burden" becomes a subsidy—and substantial distortions are introduced into the economy. Tax shelters have grown rapidly to take advantage of these provisions.

We recommend replacement of the present depreciation rules and the investment credit by a system of "real" economic depreciation. Such a system would provide depreciation deductions adjusted for inflation, so that a business could recover its investment tax-free in dollars of current purchasing power. This would achieve neutrality in the treatment of assets across industries and eliminate other distortions. Many participants felt that, in order to promote economic growth and international competitiveness, it would be unwise to eliminate all special incentives for investment in plant and equipment. It was agreed that, if an investment incentive is retained, it should be designed to minimize discrimination among industries.

There was general agreement that the inflation component of capital gains should not be taxed. The method would be to adjust the cost of assets for inflation between the time they were purchased and the time they were sold. Although such adjustments would add complications for taxpayers (mainly in keeping track of the exact dates when small investments are made, for example, in mutual funds and stock purchase plans), it is important to avoid overtaxing investment income during periods of inflation.

Most participants agreed that capital gains should be treated as ordinary income if they are adjusted for inflation and if the top marginal rate is substantially reduced as a result of base broadening. Others felt that lower rates should be applied to capital gains than to ordinary income in order to promote investment and risk taking. Promoting risk taking could also be accomplished by raising the limit now imposed on the deductibility of capital losses or by eliminating such limit after taking into account unrealized gains on assets with readily determinable values. Unrealized gains on property transferred by gift or upon death should be taxed.

Another income source that is affected by inflation is interest. Part of any interest payment is a reimbursement by the borrower to the lender for the erosion of the capital value of the loan as a result of inflation. To adjust for inflation, the inflation component of interest received by lenders should not be taxed, and the deduction for the inflation component of interest expenses should be denied. Such adjustments are complex and difficult to make for all assets, and approximate methods have been proposed as a substitute. More refined methods are necessary for financial institutions and larger corporations than for other taxpayers.

Indexing of interest even on an approximate basis is desirable on both equity and economic grounds. However, the denial of even a portion of the interest deduction on home mortgages is widely regarded as politically unacceptable. Nonetheless, we believe that the allowance of a full deduction for home mortgage interest, coupled with curtailment of the deduction for other interest as a result of indexation, would introduce unnecessary complications and encourage many people to take advantage of the mortgage interest deduction to finance the purchase of other assets. Because of these complications, some felt that indexing of interest should be avoided as long as the inflation rate remains at moderate levels.

The present tax system encourages debt over equity financing because dividends are taxed at both the corporate and individual levels, whereas interest is taxed only at the individual level. Most of the participants supported some modification of the present provisions in order to reduce or eliminate the so-called double taxation of dividends. One possibility is to allow a deduction for all or part of dividends paid by corporations. Another is to give individual taxpayers a credit for the taxes paid at the corporate level. The dividend deduction reduces the corporate tax for tax-exempt and foreign shareholders as well as for U. S. shareholders, while the dividend credit provides relief only to taxable shareholders. Other participants considered such measures too costly of revenue and would prefer a nondiscriminatory incentive for new investment.

Correction of the deficiencies in the taxation of business and in-

vestment income would improve the allocation of economic resources and increase economic efficiency. Interest rates may decline as a result of indexation because lenders would be encouraged to lend more and borrowers would be discouraged from borrowing. However, the proposed reforms may have serious short-term distortive effects. Adequate transition rules would need to be adopted to avoid serious harm to the economy.

THE INDIVIDUAL INCOME TAX

A properly designed personal income tax would include all income in the tax base and provide deductions for expenditures that clearly reduce ability to pay. The present federal income tax violates this rule in numerous respects. We believe that most of the exclusions, deductions, and credits in the tax law should be eliminated, so that the tax return can be simplified and tax rates can be significantly reduced. The net effect of these changes, together with the rate structure adopted, should, however, maintain approximately the same degree of progressivity in effective tax burdens as under current law.

The tax preferences now in the law are not confined to any particular income group. Where feasible, all forms of income should be included in the tax base. Adequate personal exemptions, standard deductions (now called zero bracket amounts), and earned income credits should be the mechanisms by which the poor are relieved from tax liabilities. From 1969 until 1978, Congress followed the principle that minimum taxable levels should be at least as high as officially estimated poverty levels. This principle should be reintroduced as quickly as possible, and the resulting exemptions and zero bracket amounts should be automatically adjusted for inflation, as under present law. The earned income tax credit, which reduces the tax burdens of low-income families with children, should also be automatically adjusted for inflation.

Today, unemployment compensation benefits are included in taxable income only for those with other income of at least $18,000 if married and $12,000 if single. Half of social security benefits are included for those with other income of at least $32,000 if married and $25,000 if single. We believe that equal treatment of those with the same income would be better served if income limitations on the taxation of unemployment and social security benefits were gradually removed. Rates and exemptions should be adjusted to avoid an increase in the tax burden of low-income groups.

Individual retirement accounts (IRAs) were originally designed to permit employees not eligible for a private pension plan to set aside their own savings for retirement. In 1981, all employees were allowed to deduct contributions to an IRA, even if covered by a private plan.

Most people have simply transferred assets from other accounts to IRAs without increasing their saving. We believe that IRA contributions should be allowed only to the extent that the employer has not made a current provision for the employee up to the limit allowed by law.

Fringe benefits, in general, should be treated like cash wages for tax purposes. Many participants believed that employer contributions to nondiscriminatory health insurance and group term life insurance plans, however, should be excluded up to a reasonable minimum on social policy grounds.

Beneficial treatment of the private pension system, in general, should be retained but confined to its purpose of sponsoring retirement saving. Borrowing by participants should be precluded and other improvements made to prevent abuse.

The tax exemption for interest on bonds issued by state and local governments to pay for public services and facilities should be retained. However, the tax exemption for interest on bonds issued to finance investments for nongovernmental purposes should be removed. There is no reason why the federal government should subsidize such investments. Further consideration should be given to provisions of optional issuance of taxable state and local bonds or a federal tax credit to the holders of taxable bonds to minimize windfall gains to high-bracket taxpayers.

Personal deductions are too generous. We believe that interest on consumer credit should not be deducted and a limit should be placed on the deduction for mortgage interest. Some felt a deduction should be permitted for all interest up to the amount of property income reported on the tax return plus $10,000 or $15,000. Others would allow a deduction only for principal-residence interest on a mortgage amount up to, say, $150,000 plus an amount equal to the taxpayer's property income. Again, liberal transition provisions would be needed to avoid hardships.

A deduction for charitable contributions should be retained, but the deduction should be limited to substantial gifts and donations, say, above 1 or 2 percent of income. If unrealized gains on transfers by gift or at death are taxed as recommended, the deduction for gifts of appreciated property to charity should be limited to the inflation-adjusted cost of the property to the donor rather than the total value of the property, but not otherwise. The charitable deduction for nonitemizers should be eliminated. Some members of the group felt that the deduction should be retained in its present form on the grounds that it encourages gifts to charity by people in all income classes. Others proposed that the deduction should be converted to a tax credit.

The deduction for state and local taxes loses a great deal of reve-

nue and indirectly subsidizes local public services. Most of the participants supported reduction or elimination of state and local tax deductions on the grounds that the federal government should not encourage or discourage these activities through tax deductions. Some felt that a deduction should be maintained for at least state and local income taxes. In theory, the more efficient approach would be to provide grants to state and local governments for outlays that are of national concern through categorical grants or revenue sharing. In practice, there is little likelihood that direct federal grants to states and localities will soon take the place of the indirect aid now provided by the deduction of state and local taxes. Deductions should be phased out gradually over a period of years, however, to avoid severe disruptive effects on states with social obligations funded by higher tax rates.

Outlays for unusual medical expenses and large casualty losses reduce ability to pay. The present deductions for medical expenses in excess of 5 percent of income and for casualty losses in excess of 10 percent should be retained.

DEFICIT REDUCTION AND TAX REFORM

Unless action is taken by Congress and the president, the federal budget will run large and unacceptable deficits for years to come. Deficits of this magnitude raise interest rates, increase the exchange rate of the dollar, and impair the competitiveness of U. S. industry in world markets. Eventually, the large deficits are likely to crowd out private investment and reduce the rate of economic growth. A major economic priority for Congress should be to take action to significantly reduce the deficits.

Both tax reform and deficit reduction are important objectives in their own right. We should not hold deficit reduction hostage to tax reform should the latter be delayed; neither should we hold tax reform hostage to the deficit. We believe our recommendations have merit—with or without deficits.

The administration and Congress have a rare opportunity to make tax reform a reality. The public has made it clear that they are unhappy with the current tax system, and a number of proposals have been put forward that would make the great majority of taxpayers better off. It would be a mistake to underestimate the political strength of those who wish to use the tax system to accomplish a variety of special purposes—or the value of some of their individual causes. But based on our own deliberations, it appears both feasible and desirable to eliminate most, if not all, of these special provisions. The end result would be a simpler, fairer, and more efficient tax system with lower rates.

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TAXING CORPORATE DISTRIBUTIONS OF APPRECIATED PROPERTY: REPEAL OF THE *General Utilities* DOCTRINE AND RELIEF MEASURES

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I strongly oppose repeal of the *General Utilities*[1] concept with respect to a sale or distribution of assets in the course of a complete liquidation. As has been suggested, the effect of such repeal would be to revoke sections 336[2] and 337[3] and, to the extent that section 338[4] is part of section 337, much of the practical effect of section 338 and section 334(b)(2)[5] before it. The result of such repeal would be to increase the rate of tax on gains which are essentially investment or inflationary gains. The imposition of this double tax burden would cause a rate increase from 20% to 42.4%. Despite the many perceived simplification gains that could flow from such change, the adverse economic effects of more than doubling the capital gain rate on this element of corporate investment are too great, and the simplification gains are uncertain. The existing effects of sections 336, 337, and 338 in providing for a single tax burden on the distribution or sale of assets upon termination of a corporate business in complete liquidation reflect good tax policy and should not be disturbed.

This is not to say that no changes should be made. The provisions

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1. General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).
2. I.R.C. § 336 (1982).
3. I.R.C. § 337 (1982).
4. I.R.C. § 338 (1982).
5. I.R.C. § 334(b)(2) (1982).

of the pending House and Senate bills that would impose a corporate-level tax on *ordinary* non-liquidating distributions of appreciated property are sound. There is no strong tax policy reason to exempt a gain in such cases from the corporate level tax. Non-liquidating corporate distributions are ordinarily made in cash, and if the corporation will continue in existence, the corporate-level gain may appropriately be taxed as if the corporation had sold the property and then made a cash distribution. Indeed, it was for this reason that section 337 was limited to distributions in complete liquidation in the 1954 Code.

The gain with respect to inventory or other property primarily held for sale to customers upon a sale or distribution of those assets in the course of a complete liquidation should also be taxed. Thus, the bulk sale inventory rule in the present section 337 should be repealed. These gains arise from ordinary ongoing business activity of the corporation and should be taxed as ordinary income even in the context of a complete liquidation. To the extent that we do have a two-tiered tax system for corporate income from ordinary business operations where the income is distributed to the shareholders, it properly applies to such income that is distributed in liquidation as well.

Congress acted in 1980 to amend sections 336 and 337 to tax the LIFO reserve in complete liquidations. There is no compelling reason to treat FIFO inventory gains any more favorably. The present bills limit the *General Utilities* concept so that it does not apply to non-liquidating distributions, except in the case of spin-offs or distributions to an 80% or more corporate parent shareholder. The taxation I have suggested of all inventory gains at the corporate level, even in the course of complete liquidations, would achieve significant simplification gains sought by the proponents of repeal of the *General Utilities* concept. Beyond such a framework, however, there might well be no simplification gains. Congress and affected taxpayers will not tolerate the adverse economic effects of repeal of sections 336, 337, and 338 so as to increase the capital gains rate resulting from a complete liquidation from 20% to 42.4%. Congress would either exempt capital assets and section 1231[6] assets that were held for more than some period of years, such as three years, or would adopt some form of shareholder credit for the corporate capital gains tax. Either step would leave in place many of the complexities and uncertainties of existing law which the opponents of *General Utilities* seek to eliminate.

The acid test of the desirability of repeal may be simply illustrated. A group of investors contribute one million dollars to a corpo-

6. I.R.C. § 1231 (1982).

ration. They construct a building and operate it for rental income for a long period of years. The value of the building increases to three million dollars because of inflation or general increase in real estate values. The investors decide to sell their investment. If section 337 were repealed they would incur an effective tax burden of 42.4% on the two million dollars of appreciation as opposed to 20% that they would have incurred if they had operated through a partnership or had made a comparable alternative investment. There is no tax policy reason supporting the increase in taxation of the gain derived from corporate investment which did not result from ongoing business activities of the corporation. Actually, if the investors had held the building prior to incorporation and it had appreciated in value at that time, the problem would be exacerbated because the pre-incorporation gain would also be subject to the double tax burden.

This example reflects a widespread problem in the real world that would result from repealing the *General Utilities* concept. There are a very large number of closely held businesses in the United States holding section 1231 assets which have been used for many years in the corporate business, and have appreciated substantially in value. The real estate involved might be a manufacturing plant or retail store location, rather than a building held for rental. The appreciated assets might instead be patents or some unique collection of personal property which is not readily replaceable and has increased in value, such as a specialized manufacturing facility.

The treatment of goodwill and going concern value by the proponents of repeal is ambiguous. In theory, this gain should also be taxed at the corporate level if other unrealized gains in corporate assets are to be taxed on a sale or distribution in complete liquidation. The Senate Finance Committee Subchapter C staff report[7] proposed, however, that in a so-called cost basis acquisition in which gain would be recognized at the corporate level in a complete liquidation, unallocated acquisition premium or goodwill would not be taxed at the corporate level but would be given a carryover basis. That, however, would not solve the problem as to intangible assets other than goodwill, such as patents and trademarks, and could create new controversies as to what is goodwill. For example, the question would then arise whether know-how, trade secrets, trade names and the like are to be treated in the same manner as patents or trademarks, or as part of some unallocated premium. Furthermore,

7. STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 1ST SESS., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS (Comm. Print 1983).

the acquiring company might well discount their value for the absence of a stepped-up basis, since they may be sold by it in the future. If that were so, the shareholders of the target company would still bear an implicit tax burden at the corporate level.

Finally, the treatment of such goodwill value in complete liquidations involving distribution of assets in kind is also unclear. If the parties seek to liquidate their corporation, and operate their business as a partnership, the absence of section 336 would cause the value of such assets to be taxed at the corporate level. This could result in the parties being forced to sell their business to others or finding some other way to avoid the double tax burden as to such asset values.

The central argument of the proponents of repeal is that we have a two-tiered tax system in which income is to be taxed both at the corporate level and the shareholder level, and that the *General Utilities* concept is contrary to that system. In fact, however, we have never had a truly unintegrated corporate tax system in which tax is paid at the corporate level and a second tax is paid on corporate income by the shareholders. Over the seventy or more years that our corporate income tax system has developed, we have had a compromise system in which a double tax has been imposed only on ordinary earnings from regular operations to the extent that they are distributed to the shareholders as dividends. Only a single tax has been imposed upon extraordinary events, such as a sale or distribution of assets pursuant to a complete liquidation. In reality, to a large extent, as Peter Faber suggested earlier this morning, we have had only a single ordinary income tax on regular corporate earnings because of the ability to retain earnings. By reason of our provision for a step-up in basis of assets at death, earnings which had been taxed at ordinary rates at the corporate level have to a large extent been retained and have not been taxed again at the shareholder level. At most they have been subjected to a capital gains tax on sale of the stock at the shareholder level. A large percentage of corporations in the United States, both publicly held and privately held, retain and reinvest in their businesses a large percentage of their annual earnings, partly as a result of the tax advantages to their shareholders that flow from this policy.

This is an entirely healthy system. The top corporate tax rate and the top individual rate are roughly the same. There should be limits on the taxation of income from capital so that capital formation is not inhibited or misdirected away from business investment. Furthermore, to the extent that we provide incentives through tax allowances such as the investment credit, ACRS, the research and development credit, or the intangible drilling cost deduction, there should be no preference for operating in or out of the corporate structure. Virtually all major foreign industrialized countries, includ-

ing the entire European Economic Community and Canada, have moved toward a single integrated tax structure in which only a single income tax is paid on business earnings. Economists tend to favor such a system to avoid undue burdens on capital investment. We have greatly moderated our double tax burden on capital by the types of incentives previously mentioned, and as a practical matter the effect of our present corporate tax structure is that, by a variety of means, we have achieved what is a single tax on the returns from capital. This allows us to remain competitive in the world economy.

There is no important reason at this time to disturb this carefully developed balance that has resulted from seventy or more years of experience in refining our corporate tax system to accomodate the needs of our economy and our society. It is particularly unwise to do so in a way that would impact harshly on privately held smaller companies. The primary consideration affecting our corporate tax structure should be economic efficiency, not simplicity or undue concern with abuse and manipulation that we have been able to control by other means.

It is important to recognize that the impact of repeal of sections 336, 337 and the principal effect of 338 would be largely on closely held family businesses. Large publicly held corporations seldom undergo complete liquidations. The short-term effect would be to bias the decision of these families in favor of merging their family companies into large publicly held corporations in a tax free exchange for stock of those companies, rather than allocating their capital to other uses that might be more efficient. If that were so, the tax law would further interfere with market allocation of capital. In the long run, businesses might tend to avoid incorporation wherever possible. Our capital markets, which are the largest and most efficient in the world, are based on financial instruments of corporations, not those of unincorporated businesses. These markets might adjust, but at a significant cost in the capital formation process. New instruments subject to new dimensions of risk would be required to replace our existing corporate capital instruments.

Many family businesses in the United States hold a wide range of business assets, including real estate from which the business is operated. Mostly as a result of inflation these assets are likely to have appreciated substantially in value over a long period of years. Many family companies have been operated through several family generations, thus greatly increasing the inflationary components of these gains. Even though the family company may have been operated for

many years, the family may have become so large, or the interests of different family members may have become so diverse, that it may make greater economic sense for the family to liquidate the corporation, possibly selling all or a part of its assets or selling their stock, and then to undertake other business ventures. It may have become economically more efficient for third parties to acquire the business. There are a wide range of reasons why it may become appropriate for the family to terminate its corporate activities by complete liquidation.

These families have operated on the basis of certain fundamental assumptions as to our taxing system as it has existed for the last fifty years, even prior to the time that the *General Utilities* case was decided in 1935. Those assumptions include a clear understanding that under our tax system, upon a decision to completely liquidate the business, they could do so and incur only a single capital gains tax on the appreciation in value of the underlying assets of the business. This has been the case whether they sell those assets to third parties or take their respective shares of the assets in kind to operate as sole proprietorships or as partnerships. In such a case they seek to put their capital to its most efficient uses in our economy.

A single capital gains tax on this terminal transaction, as if the gain had arisen from other investment assets held by them, is entirely appropriate. Much of the gain is probably inflationary gain, and thus it deserves only a single corporate capital gains tax. Even the balance of the gain which is likely to be attributable to real assets or intangible assets is by its nature essentially an investment gain and not a gain attributable to a regular business activity that is typically taxed at higher rates. A tax of 42.4% on this gain is not justified. The result would be that families wishing to terminate their family businesses effectively will have one option: to find a publicly held corporation and take its stock for their company. A publicly held corporation with tax losses created by ACRS deductions or otherwise, or with unuseable investment credits, presumably could elect to step-up the basis of the assets at the corporate level in a so-called cost basis acquisition using its own stock at only a minimal tax cost.

It is important to recognize that tax will be paid at the shareholder level on the appreciation in value of assets held by the corporation in a complete liquidation except to the extent that the Code provides explicitly for tax exemption to serve other social or economic policies. The shareholders' gain on liquidation consists of two elements, retained earnings and appreciation in value of the company's underlying assets. The shareholder may, of course, have bought his shares at a time when such elements already existed to some degree. If so, his predecessor will have paid tax at the shareholder level on such elements. Retained earnings and appreciation in

value of corporate assets ultimately always incur a tax at the shareholder level, except to the extent the stepped-up basis at death occurs or the shareholder is tax exempt. Furthermore the recapture rules insure that the ordinary income portion of asset appreciation ultimately is taxed as ordinary income. Retained earnings by definition have already been taxed at the corporate level. What remains is the capital gains portion of the appreciation in value of corporate assets, which ultimately is taxed at the shareholder level except where there has been an intervening death of the shareholder or where the shareholder is a tax-exempt organization or person. Repeal of *General Utilities* in the case of complete liquidations would tax this appreciation twice, whereas if the business had been operated in noncorporate form this double tax would not have been incurred.

It is incorrect to argue that taxation at the corporate level is necessary to prevent tax avoidance arising from the fact that the shareholder may be a tax-exempt organization, or a foreign person not subject to U.S. tax, or because the gain may be eliminated by a step-up in basis at the death of a shareholder prior to the distribution in complete liquidation. Each of these exemptions from tax presumably serves some economic or social policy that Congress has seen fit to adopt in the Internal Revenue Code. It may well be, of course, that the scope of these exemptions should be reconsidered carefully, but there is no tax policy justification for repealing these exemptions only with respect to gains which arise from corporate investment. The step-up in basis at death, for example, is obviously a major loophole in the tax system, but Congress for whatever reason sees fit to retain it. It cannot properly be partially repealed in a manner that discriminates against corporate investment.

The principal advantages claimed for repeal of *General Utilities* are the elimination of the substantial complexity and uncertainty that it creates. It is argued, for example, that repeal would permit repeal of the collapsible corporation provisions. It is more likely that Congress would not repeal the *General Utilities* concept outright, but rather that Congress would ameliorate the effects of any such change either by exempting section 1231 or capital assets held for some period of years or by introducing a shareholder credit for the corporate-level capital gains tax. If either of these steps were taken, it might be necessary to retain the collapsible corporation provisions and many of the other existing complexities and uncertainties that arise out of the *General Utilities* concept.

Accordingly, we should not repeal *General Utilities* as to sales or distributions of assets in a complete liquidation and impose a double tax burden on asset appreciation existing at that time. An effective tax rate of 42.4% on such gains, as opposed to a 20% rate on other investment gains, would indeed have serious adverse economic effects, particularly on privately held companies. It could create a bias causing owners of family companies contemplating liquidation to merge their companies into publicly held companies in exchange for stock of those companies. In that event, capital would not be directed to its most efficient uses in our economy. We have developed our existing system over a long period of years to respond to the needs of our economy, and we can rectify abuses as was done in TEFRA and in prior revenue acts. There is virtue in stability in our fundamental tax structure.

The Non-Business Interest Deduction

(By John S. Nolan)

Introduction

In a comprehensive base income tax system, all interest paid should be deductible, though on an accrual basis. Denial of the deduction is an imperfect adjustment for failure to tax income which the interest expense appears to be financing, whether it be the value of the use of owner-occupied housing or consumer durables, tax-exempt interest, increases in value of assets not "realized" for income tax purposes, or otherwise. Since money is fungible, such an imperfect adjustment is seriously flawed, resulting in major inequities among taxpayers and creating serious administrative and complexity problems. On the assumption that it is politically and practically impossible to extend the income tax system to all income, this paper will explore the imperfections of addressing the effects of income exclusions by denying a deduction for interest expense. The importance of denying interest deductions to maintain the integrity of the tax base will be weighed against those imperfections. The paper will recommend a proposed solution as to this element of the non-business interest deduction question.

A separate fundamental consideration with respect to interest generally, business and non-business, is the problem of inflation. Interest rates reflect an inflation component to compensate the lender for the anticipated loss of real value of the funds lent from the time of the loan until its repayment. The debtor would obtain a windfall in repaying the loan in cheaper dollars but for this addition to the interest obligation. As a result, part of the interest payment is a transfer of capital, a repayment of principal, rather than a true payment for the use of the funds—i.e., an income and expense item.

If all taxpayers were in the same tax bracket, the market might adjust for this transfer of the tax obligation from the debtor to the creditor by an effective gross-up. In fact, however, tax brackets vary widely, and the existing treatment has created an incentive for zero tax rate lenders, such as pension funds, to make loans. It also affects various investment decisions, such as the allocation of investment funds between debt and equity and between long-term and short-term financing.

The overstatement of interest expense deductions also encourages transactions in which funds are invested in assets producing income which is tax-exempt or tax-deferred because of departures from a comprehensive income tax base, whether because of the "realization" requirement of our tax system for income recognition, accelerated depreciation, tax incentives for various industries, or otherwise. Interest deductions are a key element in most tax shelter plans, which are built upon leveraging.

Accordingly, revision of the interest deduction must consider the need for an adjustment for inflation. This paper will explore the recent Treasury proposal for an

inflation adjustment but will not recommend for or against such a solution. The concept requires further development which is beyond the scope of this paper.

TAX REFORM PROPOSALS—RESTRICTING THE DEDUCTION ASIDE FROM INFLATION CONSIDERATIONS

Various substantive tax reform proposals would deny the deduction of non-business interest. The recent Treasury tax reform proposals would allow a deduction for non-business interest only–(1) for interest on debt secured by the taxpayer's principal residence (to the extent such debt does not exceed the fair market value of the residence); plus (2) interest up to $5000 plus the taxpayer's net investment income.[1] Other proposals adopt varying approaches to the matter.[2] The deduction of mortgage interest on owner-occupied homes, and the deduction of non-mortgage interest in excess of investment income, are treated as tax expenditures in the budget, in amounts, respectively, of $23.5 and $6.6 billion in 1984, and $39.8 and $9.6 billion in 1989.[3]

The denial of a deduction for non-business interest is sometimes supported as removing an incentive for consumption, thereby inducing an increase in saving. Value judgments are obviously made in the tax reform proposals denying a deduction for non-business interest by nonetheless allowing, for example, deduction of mortgage interest as to owner-occupied housing, or only as to the taxpayer's principal residence, and for interest on debt to finance education. Informed judgments as to economic effects of denying the deduction need to be made on a more careful basis, however. The effect, for example, of denial of a deduction for interest incurred to purchase personal automobiles on U.S. employment in the automobile industry and the availability of adequate transportation to persons not served by mass transit facilities, and for recreation purposes, must be considered in any policy judgment to deny a deduction for interest to restrain consumption. The effects of denial of a deduction on the housing industry, the retail sales industry, and GNP growth generally must all be thoroughly evaluated. Among other effects, the value of existing housing and consumer durable goods, for example, might fall, even if the disallowance does not extend to existing financing in place, since the supply of potential purchasers will be substantially reduced.

These economic effects are beyond the scope of this paper, but it seems clear that they have not been adequately addressed in the various tax reform proposals.

INDEXING OF INTEREST PAYMENTS

The Treasury tax reform proposals would impose a further fundamental limitation on the deduction for interest paid—non-business as well as business interest. That portion of interest payments deemed to be in excess of the real interest rate, and thus to be attributable to inflation, would be non-deductible by the debtor-payor and would be excluded from income by the creditor-recipient. Such portion would, in effect, be treated as a payment of additional principal by the debtor to reflect the inflationary reduction in his real obligation and to make the creditor whole on his claim in real dollar terms.[4]

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[1] "Tax Reform For Fairness, Simplicity, and Economic Growth," The Treasury Department Report To The President, Vol. 2 General Explanation 331–333 (November, 1984) (hereinafter referred to as the Treasury Report). The proposal would extend also to the taxpayer's share of interest expense of Subchapter S corporations, except where the taxpayer actively participates in the management, and the taxpayer's share of interest expense of limited partnerships in which the taxpayer is a limited partner.

[2] H.R. 3271, 98th Cong., 2d Sess., the "Fair Tax Act of 1983", commonly known as the Bradley-Gephardt bill, would deny the deduction of non-business interest (other than interest as to housing occupied by the taxpayer or any member of his family) in excess of the taxpayer's net investment income. H.R. 3271 would also allow so-called "personal deductions", including non-business interest, only for purposes of determining income subject to the lowest tax bracket in that bill, 14 percent, thereby effectively converting the deduction into a 14 percent credit. H.R. 6165, 98th Cong., 2d Sess., the Fair and Simple Tax Act of 1984, commonly known as the Kemp-Kasten bill, would deny deduction of "consumer interest", defined as interest deductible solely by reason of section 163, except interest as to residential property or to pay educational expenses of the taxpayer's immediate family. See also H.R. 3516, 98th Cong., 2d Sess., the Flat Rate Tax Act of 1983.

[3] "Staff Estimates of Federal Tax Expenditures," Joint Committee on Taxation (November 13, 1984).

[4] Treasury Report, pp. 193–200.

The adjustment is achieved by assuming a real rate of interest of 6% and providing a fractional exclusion rate (percentage) based on the actual inflation rate as reflected in the Consumer Price Index. Thus, if the inflation rate were 6% for the year, the fractional exclusion rate would be 50%, reflecting an assumption that interest rates would then be 12% (6% assumed real rate plus 6% inflation rate).

The denial of an interest deduction to the extent of the fractional exclusion rate would not extend to interest on a mortgage on an individual's principal residence, to the extent the debt does not exceed the value of the residence, nor to an individual's additional interest expense up to $5,000.

Otherwise, the fractional exclusion rate would be applied to the *net* interest income or *net* interest expense of any individual or corporation. Interest received or paid by a partnership or other pass-through entity would be attributed to the partners or other owners. The benefit of the fractional exclusion for interest income would not pass through to the beneficiaries of qualified retirement plans or IRA's.

The fractional exclusion rate would be applied to interest income and expense before application of the limitations on deduction of non-business interest previously described.[5]

The Treasury explanation acknowledges that the proposal is arbitrary, less ideal than recognizing the inflationary reduction in principal as a loss to the creditor and income to the debtor on an annual basis, and subject to a number of potential tax avoidance possibilities. Nonetheless, it is defended on the ground that it more accurately measures real economic income than does present law.[6]

The Treasury proposal requires more analysis of the question whether it is a necessary and appropriate method of dealing with the inflation problem.

Thus, the Treasury proposal would apply as of January 1, 1988, to all interest on indebtedness, regardless of when the debt was incurred. With respect to pre-existing debt, the parties struck their bargain on the basis of pre-existing law. If both parties were in the same tax bracket, for example, it should be assumed that the interest rate reflects tax effects of the debtor obtaining a deduction for the full interest payment, even the inflationary element, and the creditor being taxable on these amounts. The proposed rule would upset that bargain and create windfall gains and losses.

The Treasury proposal assumes a real rate of interest of 6 percent for all transactions, regardless of risk. If the inflation rate is 6 percent but the loan involves a high degree of risk, the interest rate might well be 18 percent even if, in general, the real rate of interest were 6 percent. To deny a deduction for 9 percent of the interest paid in such a transaction, and to exclude 9 percent from the creditor's income, is an incorrect adjustment.

Similarly, assume a loan is made at a time when inflation is 2 percent so that if the real rate of interest is 6 percent, the rate set by the parties (ignoring the prospect of further inflation) is 8 percent. The inflation rate later unexpectedly increases to 6 percent while the loan is still outstanding. If the debtor's interest deduction and the creditor's income is determined by reference to a 4 percent rate under the Treasury proposal, an incorrect adjustment results. An amount equal to 6 percent of the loan principal represents a restoration of the real value of the funds loaned, so only 2 percent should represent the income and expense amount.

The Treasury proposal will be extremely complex to administer, regardless of its apparent simplicity. As suggested, it creates severe equity problems. Further consideration must be given to the range of transactions to which it should apply. The exclusion of home mortgage interest plus interest up to $5,000 will avoid adjustments to the interest deduction with respect to most non-business interest. Consideration should be given to exclusion of short-term debt which is outstanding. for example, for less than one year where the inflation effects are less significant.

More fundamentally, more attention must be given to the question whether this complex adjustment is necessary if the income tax base is made much more comprehensive, as the Treasury Report proposes. The Treasury proposals would tend to eliminate most tax shelter arrangements. While not extending the tax base to many tax-exempt organizations, it is possible that interest payable to tax-exempt creditors such as pension funds and charities could be specially treated.

If the number and type of loan transactions which need to be affected by the limitation on the interest deduction could be greatly limited, a more suitable type of inflation adjustment for debt might be feasible. For example, the adjustment in such case could be based on the particular loan transaction at the time it was made,

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[5] Treasury Report, pp. 192, 332-333; see supra, pp. 1-2 and footnote 1.
[6] Treasury Report, pp. 197-200.

isolating the likely inflation element in the interest rate in that particular transaction. The result would be less arbitrary.

The adjustment as proposed in the Treasury Report raises serious questions of administrability and equity. Further exploration of alternatives is beyond the scope of this paper but seems essential.

ALL INTEREST WOULD BE DEDUCTIBLE IN AN IDEAL INCOME TAX SYSTEM

Aside from inflation considerations, interest represents an annual, recurring cost for the use of money which produces annual returns to the borrower for additional investment or consumption. In a perfect income tax structure in which the annual returns from all assets (including use for consumption) were treated as income, all income were treated the same, and the increase or decrease in value of the taxpayer's assets each year were appropriately taken into account in determining annual income, there would be no occasion to deny a deduction for interest expense.

The difficulty in the U.S. tax system arises because the annual returns from some important assets which are used for consumption (for example, owner-occupied residences) are not treated as income, some investment income is not taxed (for example, interest on state and local bonds), some investment income is preferentially treated (for example, long-term capital gains), recognition of income may be deferred by the realization rule (unproductive assets held for appreciation), and business taxpayers are granted a variety of tax preferences which result in deferral of income (often for such indefinite periods as to be virtual exemption).[7]

Thus, if all of the taxpayer's real income were subject to tax, the income from all assets resulting from borrowing would enter the gross income stream and would be appropriately reduced to net income by interest expense. Since, however, so much real income is not currently taxed in the U.S. income tax system, interest on debt used to provide assets which do not produce currently taxable income offsets other currently taxable income. This is sometimes referred to as "tax arbitrage".[8] Denial of the interest deduction, however, would introduce a major horizontal inequity, since taxpayers with other assets providing taxable returns would substitute a larger investment in the tax-preferred asset by liquidating other such assets instead of borrowing. The more appropriate response in conceptual terms would be to eliminate the tax preference for the income. Since this is impossible in many instances for administrative reasons,[9] the focus has come to be upon restricting the tax arbitrage by denying in various degrees the non-business interest deduction.

DEBT TO FINANCE CONSUMPTION

The equity difficulties are readily apparent. Interest on a mortgage on an owner-occupied personal residence offsets otherwise taxable income. Denial of a deduction for the interest on the mortgage to compensate for the fact that the annual return from such investment—the value of the use of the residence—is not treated as

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[7] See Klein, *Borrowing to Finance Tax-Favored Investments*, 1962 Wisc. L. Rev. 608 (1962). The author analyzed the treatment of interest as to tax-exempt bonds and insurance and annuity policies and mortgage interest on owner-occupied homes. He concluded that the tax advantage is not the interest deduction but the preferential treatment of the income from certain forms of investment. Limitations on the interest deduction merely limit the group to which tax-preferred income is available to those persons able to finance such investments with their own funds. He argued that interest deduction limitations, if any, be based upon the need to protect tax revenues, the desire to prevent deterioration of taxpayer morale, encouraging savings, and consideration of tax treatment of homeowners as compared to renters.

[8] This concept is developed more fully in another paper in this series by Alvin C. Warren entitled "Accelerated Capital Recovery, Debt, and Tax Arbitrage."

[9] It is generally agreed that it is not feasible to tax individuals on the current value of the use of their owner-occupied housing or consumer durables, such as personal automobiles. See H.R. Rep. 658, 94th Cong., 1st Sess. 102 (1975). The difficulties of valuation, and of achieving public understanding of the concept, are simply too great. On the other hand, important proposals have been made to tax the rental value of owner-occupied housing. Commission To Revise The Tax Structure, "Reforming the Federal Tax Structure," p. 18 (Fund For Public Policy Research, 1973). See also Comments by Charles E. McLure, Jr., "Comprehensive Income Taxation," p. 72 (Brookings Inst. 1977). The United Kingdom at one time imputed income to owner-occupied housing, but it was abandoned. Canada has sought to deny deductions for non-business interest, and the result has been substantial litigation and inequity. Bale, "The Interest Deduction Dilemma," 21 Canadian Tax Journal, pp. 317–336 (1973). For similar reasons, the annual valuation of all investment assets of individuals presents insuperable administrative difficulties. On the other hand, the exemption from current taxation of interest on state and local bonds, earnings on pension and profit-sharing plans and IRA's, and other assets reflects legislative judgments that could be reevaluated in light of the policies served by these exemptions.

income would have very uneven effects. Those taxpayers with investment assets producing income subject to tax could merely sell those other assets and substitute a larger equity in the residence, the returns from which are not taxed. The net result is that such a person would incur no net tax increase. On the other hand, a person not owning investment assets producing currently taxable income, and thus unable to liquidate such assets to repay the mortgage on the residence, would necessarily suffer a tax increase. To the extent that the returns from home ownership are not taxed in order to encourage such home ownership, the policy would be frustrated by uneven treatment among taxpayers, favoring wealthier classes.

If the deduction is allowed only as to mortgage interest as to a principal residence, the same inequities will still exist as to second homes, acquisition of new automobiles, and purchase of other consumer goods.[10] Mortgages on principal residences would be increased wherever possible to finance other consumer goods. Efforts to deny interest on the refinancing of principal residences would create administrative difficulties similar to those under Code § 265(2) denying the deduction of interest to purchase or carry tax-exempt bonds.

The underlying principle involved is equal treatment of taxpayers who borrow to finance personal, investment, or business activities and those who finance such activities from their own capital.[11] This principle argues with equal force against denial of a deduction for interest to finance purchases of *any* consumer goods. This is so despite the fact that the returns from the assets acquired (use of consumer goods) are not taxed to encourage their ownership or credit purchases, whether personal residences, automobiles, durable consumer goods, or otherwise, and probably could not be taxed for administrative reasons.[12]

A contrary equity consideration is that renters do not obtain the same income tax exclusion of the value of the use of owner-occupied housing or other consumer durable goods as do owners. This discrimination could be addressed, albeit imperfectly for reasons already described, by denying a deduction for interest to finance ownership of such assets.

In *Blueprints*, the Treasury Department weighed these various equity considerations in proposing a comprehensive income tax base. Treasury concluded that there should not be a denial of the non-business interest deduction. The report states:

Nevertheless, a case may be made for disallowing interest deduction for borrowing identifiably for the purpose of financing an owner-occupied home (or other consumer durable). Mortgage interest payments are surely highly correlated with net income produced by the associated housing, and denying the deduction would increase the tax base by an amount equal to a significant fraction of the aggregate net income from owner-occupied dwellings. For those who cannot otherwise finance home purchases, it would end the tax bias against renting. These considerations deserve to be weighed against the view taken here that the efficiency and equity gains from denying the mortgage interest deduction are insufficient to counter-balance the equity losses and the increased administrative complexity of the necessary rules for tracing the sources of funds.[13]

DEBT TO FINANCE INVESTMENT ASSETS

As to investment assets, there are existing piecemeal, and probably ineffective, limitations on the interest deduction. These seek to address the tax arbitrage problem in specific areas. Section 163(d) limits the deduction of "investment interest" to the total of the taxpayer's net investment income plus $10,000. "Investment interest" is defined as interest incurred or continued to purchase or carry property held for investment. Investment income for this purpose includes interest, dividends, rents, royalties, recapture income treated as ordinary income, and net short-term capital gain from the sale of property held for investment. Section 163(d) was enacted to limit the alleged "leveraging benefit" from deduction of interest on debt incurred to hold nonproductive investment assets (unimproved land), low-yielding stock, and other assets held for long-term appreciation.[14]

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[10] The Treasury Report recognizes this problem at p. 198.

[11] *See, e.g.*, Asimov, *The Interest Deduction*, 24 U.C.L.A. L. Rev. 749 (1977).

[12] See footnote 9, supra. The deduction of non-business interest has also been justified on the ground that it is administratively difficult to distinguish personal debt from debt incurred to purchase business or investment assets. Money is fungible. *See* infra, pp. 20–22, and *see, e.g.*, Bittker and Stone, *Federal Income, Estate and Gift Taxation*, 208 (4th Ed. 1972); Pechman, *Federal Tax Policy*, 79 (Brookings Inst. 1966).

[13] United States Treasury Department, *Blueprints for Basic Tax*.

[14] *See* Staff of the Joint Committee on Internal Revenue Taxation, *General Explanation of the Tax Reform Act of 1969*, 91st Cong., 1st Sess. 98–101 (1970).

Though enacted in the Tax Reform Act of 1969, regulations still have not yet even been proposed, and the possibility exists that section 163(d) is widely ignored.

Section 265(2) denies the deduction of interest incurred or continued to purchase or carry tax-exempt bonds, and while its intended application is reasonably well-defined by regulations, rulings, and court decisions, its actual application falls far short of such intentions and is not uniform.[15] Section 264(a) (2) and (3) impose generally ineffective limitations on the deduction of interest on loans to purchase or carry certain life insurance, endowment, and annuity contracts.[16] Section 170(f)(5) imposes a very targeted limitation on interest incurred to purchase or carry a bond given to charity where the interest relates to a period of time for which the income on the bond is not taxable to the donor, as where it is given to charity immediately before the interest payment date.

In more recent years, in the focus in new tax bills on tax shelters, there have been increasing efforts to deal with the deduction of interest on debt incurred or continued to purchase or carry assets which do not produce currently taxable income. Treasury has been given statutory authority to require cash basis taxpayers to use the accrual method for prepaid interest.[17] In the computation of the alternative minimum tax (the "AMT"), non-business interest is deductible only to the extent it is related to housing occupied by the taxpayer or his family and to the extent of the net investment income of the taxpayer.[18] Thus, it is immaterial whether the debt was incurred or continued to purchase or carry property held for investment. In the Tax Reform Act of 1984, various provisions limit the deduction of interest on a more targeted basis, usually in the same general manner as the section 163(d) rules, or limit the benefit of a tax exclusion to the extent the underlying asset is debt-financed.[19]

The interest-free loan provisions of the 1984 Act focus particular attention on the interest disallowance rules of sections 163(d) and 265(2). By recasting the transaction as one involving a gift, compensation, or a dividend, with the borrower then constructively paying market-rate interest, the borrower's interest deduction must run the gauntlet of these and other interest disallowance provisions.

A targeted attack was also made on interest incurred during construction of real estate improvements in Code § 189. The interest is not, however, required to be capitalized as part of the cost of the improvements but, together with construction period taxes, is amortized over ten years. The provision originally applied only to individuals, Subchapter S corporations, and personal holding companies.[20] It was di-

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[15] The most difficult problem is, obviously, correlating the investment and the debt. An arbitrary rule is adopted in the market discount interest disallowance rules adopted in the Tax Reform Act of 1984 (footnote 19 supra). In the case of a financial institution, unless the taxpayer otherwise establishes an appropriate allocation, an amount of the taxpayer's total interest is deemed to be market discount interest in the same ratio that the taxpayer's basis for market discount bonds bears to the taxpayer's total basis for its assets.

[16] This provision is directed at the fact that the "inside build-up" on whole life and endowment policies is not income, and that the interest accumulation in annuity contracts is not taxed until the annuity is paid out.

[17] Code § 461(g), enacted as § 208 of P.L. 94-455, the Tax Reform Act of 1976, 94th Cong., 2d Sess. (1976).

[18] Code § 55(e)(1)(D), (3)–(5).

[19] The market discount bond rules limit the deduction of "net direct interest expense" with respect to any market discount bond to the excess of such interest expense over the market discount allocable to the period for which the taxpayer held the bond in the taxable year. "Net direct interest expense" is defined as the excess of interest on debt incurred or continued to purchase or carry such a bond over the amount of interest income (including original issue discount) includible in the taxpayer's income for the taxable year with respect to such bond. Code sections 1277 and 1282, added by sections 41(a) of P.L. 98-369, 98th Cong., 2d Sess. (1984). Thus, if a taxpayer purchases $1000 of FNMA notes paying 7% interest due in 1999 for $700 by borrowing the $700 at a 15% interest rate, his interest income and interest expense for any full year would be $70 and $105 respectively. The market discount allocable to any year (assuming the purchase occurs on January 1, 1985, and the maturity date is December 31, 1999) will be $20. His current interest deduction is limited to $90. The disallowed interest of $15 ordinarily will be carried forward to be deducted when the market discount is taken into income upon redemption of the bond. The taxpayer may, however, elect to include market discount in income currently as it accrues under the ratable allocation rules, and in that event, there is no special disallowance of interest expense under these provisions. Code §§ 1278(b), 1282(b).

The debt-financed portfolio stock provisions limit the dividends received deduction proportionately to the extent that such stock is acquired with debt "directly attributable to investment in the portfolio stock". Code § 246A, added by § 51(a) of P.L. 98-369, supra. The legislative history says that there must be a direct relationship between the debt and the stock investment; there is to be no use of any allocation or apportionment formula or fungibility concept. Sen. Rep. 98-169, Vol. 1, 98th Cong., 2d Sess. 166 (1984). The usefulness of such a porous rule is, to say the least, doubtful.

[20] Pub. L. 94-455, 94th Cong., 2d Sess. § 201 (1976), the Tax Reform Act of 1976.

rected primarily at investment-type real estate, but it reached real estate used in any trade or business, no matter how active, if constructed by an individual, Subchapter S corporation, or personal holding company.[21] It was extended to corporations in TEFRA.[22]

These provisions are uneven in their application. Tax-preferred income in the form of returns on an employee's investment in qualified retirement plan benefits in any form, or an IRA, for example, may not be affected directly or indirectly by limitations on the interest deduction. Money and debt are largely fungible, as a practical matter, and an individual with investments represented by such interests in retirement benefits has a greater borrowing power than someone without such assets. Such an individual, for example, could generally obtain a larger mortgage on owner-occupied housing, including a second home, or obtain more favorable financing secured by a consumer durable, such as an expensive automobile. Interest on these debts probably would not be reached by §§ 163(d), 265(a), or the other interest disallowance rules, even if these provisions were all aggressively and uniformly enforced. Section 163(d) also provides a $10,000 exception,enabling taxpayers to service substantial debt to finance assets not producing currently taxable income.

More fundamentally, the effect of these various interest disallowance provisions is to introduce the same sort of horizontal inequity previously described. The wealthy taxpayer can obtain relatively greater benefit from tax-exempt interest, the capital gain preference, the exemption or tax deferral as to interest income inherent in life insurance or annuity products, the absence of imputed income on real estate under construction, or other such income sources simply by liquidating investment assets producing taxable returns and investing a greater equity in the underlying tax-preferred investment assets.

Limitations on the deduction of non-business interest have other curious economic effects. Thus, § 265(2) operates to deny the highest bracket investors the opportunity to acquire the entire supply of tax-exempt bonds through borrowing. As a result, state and local issuers must pay a higher rate of interest to attract investors in the lower brackets, who get less benefit from the exemption and thus require a higher interest rate to purchase such bonds in lieu of taxable bonds. The highest bracket investors then obtain a windfall, since the interest rate exceeds that which they would demand to purchase tax-exempt bonds.

These effects would be narrowed under tax reform proposals such as the Treasury proposal, which would narrow individual rates to a range of 15 percent-35 percent and reduce the corporate rate to 33 percent; Bradley-Gephardt, which would narrow the relationship between brackets to 14 percent/26 percent/30 percent, or Kemp-Kasten, which would tax all investment income at 25 percent. On the other hand, the lowering of rates in these bills will increase the rate of interest required to attract investors, thus decreasing the value of the existing stock of tax-exempt bonds. Both proposals, however, would deny exemption to state and local bond interest except on general obligation bonds, presumably enabling the highest bracket investors to capture a larger share of the total supply of tax-exempt bonds, thereby narrowing the windfall described above.

Otherwise, however, these economic effects would be increased by any extension of the disallowance of a deduction for non-business interest. They would manifest themselves in important ways. The value of existing housing and consumer durable goods, for example, might fall, even if the disallowance does not extent to existing financing in place, since the supply of potential purchasers might be substantially reduced. These economic effects must be carefully evaluated in any decision to deny deductions for non-business interest.

DEBT TO FINANCE BUSINESS INVESTMENT

The leveraging benefit inherent in the interest deduction in a tax system that does not tax currently all income extends equally as much to "business" interest. One example is the virtual exemption of banks from the application of section 265(2).[23] The effect is that banks generally reduce their effective tax rate by holding

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[21] Staff, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, pp. 25-29 (1976).

[22] Pub. L. 97-248, 97th Cong., 2d Sess. § 207(a) (1982). The concept was extended still further to personal property in the adjustments to earnings and profits made in the Tax Reform Act of 1984. Pub. L. 98-369, 98th Cong., 2d Sess. § 61(a)(1) (1984); Code § 312(n)(1). See also footnote 27, infra.

[23] Rev. Rul. 61-222, 1961-2 C.B. 58; Rev. Rul. 67-287, 1967-2 C.B. 133; Rev. Proc. 70-20, 1970-2 C.B. 499, Rev. Proc. 78-34, 1978-2 C.B. 535, but see Rev. Proc. 81-16, 1981-1 C.B. 688, indicating

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substantial portfolios of tax-exempt bonds while offsetting their interest deduction for interest-bearing accounts against taxable income.[24] If the market worked perfectly so that the interest rate exactly reflected the exemption from the flat corporate tax rate of 46 percent, there would be no real benefit to holders of tax-exempt bonds.[25] The bank, for example, would, in effect, pay implicit tax to the state or local issuer equal to the difference in interest rate from the market rate. The market does not work perfectly, however, because the supply of tax-exempts exceeds the capacity of taxpayers in the highest brackets to acquire such bonds and because of transaction costs.

The tax arbitrage problem, however, is much broader as to deductible business interest. A separate paper discusses the relationship of the investment credit and ACRS (in deferring or exempting business income from tax) and the interest deduction.[26] The problem also exists in varying degrees, however, where the Tax preference arises from tax accounting provisions allowing some taxpayers to defer income by use of the cash method, installment reporting, or other conventions; the deduction of intangible drilling costs, percentage depletion, or mine exploration or development costs; the DISC or FSC provisions; excess bad debt reserve allowances for financial institutions; or otherwise. It exists when corporate income is treated as capital gain subject to a preferential rate, whether on the disposition of § 1231 assets, the cutting of timber, or under other provisions.

Except for the limited disallowance of interest on debt of financial institutions to carry tax-exempt bonds acquired after 1982, the capitalization and amortization of construction period interest as to real estate improvements,[27] and the provisions of Code §§ 264(a)(2) and 265(2) (which have their principal application to non-business taxpayers), there are no limitations on the deduction of business interest that are relevant to the issue under consideration here.[28]

In each instance in which a business taxpayer holds assets yielding tax-preferred income, those assets support borrowing power. The debt produces assets, either the tax-preferred assets themselves (saving other assets that the taxpayer would otherwise have liquidated to acquire the tax-preferred assets) or other assets. The interest on the debt offsets taxable income from such other assets. The income tax system fails to produce sound results because of the exemption or deferral of the income from the tax-preferred assets.

THE ADMINISTRABILITY AND COMPLEXITY PROBLEM

Response to the problem of exclusion from the tax base of various sources of income by denying a deduction for interest deemed related to that income presents its own set of problems of complexity and administration. At the outset, the distinction between business and non-business interest, assuming that most business interest is to remain deductible, is not simple.[29] Where the taxpayer is engaged in an

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that the Internal Revenue Service will apply § 265(2) to interest paid on deposits incurred outside the ordinary course of the banking business or in circumstances indicating a direct connection between the borrowing and the tax-exempt obligations. See also Rev. Rul. 67-260, 1967-2 C.B. 132; Rev. Rul 71-163; 1971-1 C.B. 106; New Mexico Bancorporation and Subsidiaries v. Commissioner, 74 T.C. 1342 (1980).

[24] In TEFRA, interest incurred by financial institutions on debt to carry tax-exempt obligations acquired after 1982 was treated as a tax preference subject to the 15 percent disallowance rule in new Code § 291. Pub. L. 97-248, 97th Cong., 2d Sess. § 204 (1982). In the Tax Reform Act of 1984, the disallowance was increased to 20 percent and the definition of this corporate preference item was extended to make it clear that it includes amounts (whether or not designated interest) paid in respect of deposits, investment certificates, or withdrawable or repurchasable shares. Pub. L. 98-369, 98th Cong., 2d Sess. § 712(a) (1984).

[25] Thus, assume for simplicity that the market rate of interest on bonds of comparable risk the interest on which is taxable is 10% and that there was a flat tax rate of 50% applicable to all investment income. A perfect market would result in a 5% interest rate on tax-exempt bonds.

[26] See footnote 8.

[27] In TEFRA, Code § 189 was extended to corporations. See footnote 22, supra. As so extended, it did not apply, however, to residential housing construction period interest of a corporation other than a Subchapter S corporation, personal holding company, or foreign personal holding company. In the Tax Reform Act of 1984, the rule was extended to construction period interest as to such residential housing as well. P.L. 98-369, 98th Cong., 2d Sess. § 93(a) (1984).

[28] The full absorption inventory regulations, for example, allow all interest expense to be treated as a period cost, currently deductible in all events. Reg. § 1.471-11(c)(2)(ii)(e).

[29] See footnote 12, supra; Pechman, *Federal Tax Policy*, p. 79 (Brookings Inst. 1966); Due, *Personal Deductions* in *Comprehensive Income Taxation* (Brookings Inst. 1977) at p. 53.

unincorporated business, he may borrow on the security of his business to buy a home or a personal automobile or alternatively he may borrow on his home to finance his business. The distinction may be further obscured where the taxpayer holds interests in partnerships which incur debt and distribute refinancing proceeds, or even save him from investing capital he might otherwise have invested.[30] Money is so fungible that the attribution of debt to specific assets is often wholly unsatisfactory. The solution to this problem under existing law is that the Internal Revenue Service generally does not look beyond the labels; interest on a home mortgage is deemed to be exempt from § 163(d) or § 265(2), regardless of the use of the proceeds, and interest on a debt incurred in a business is similarly treated.[31]

The problems of identifying a relationship between the debt and the asset not producing currently taxable income ("indebtedness incurred or continued to purchase or carry" property held for investment) (tax exempt bonds)) are self-evident. As previously stated, the alternative minimum tax provisions [32] adopt more arbitrary but more certain provisions for disallowance. The existing disallowance provisions, as previously described, are not applied uniformly and deserve reconsideration whether or not they are extended in any new tax reform measures.

A central objective of any major substantive tax reform measure must be to achieve greater simplification of the system. If a decision is made to deny deductions for non-business interest in whole or in part, notwithstanding the adverse equity and economic effects previously discussed, the form of the disallowance should be dictated to the maximum degree possible by considerations of certainty and clarity of purpose and application.

THE APPROPRIATE RESPONSE

In a consumption tax, interest is not deductible, so the problems discussed here do not arise. In a comprehensive base income tax system, these problems theoretically should not arise because all income would be taxed currently. As the income tax base is eroded by provisions to encourage economic or social objectives, and as it may move partially toward a consumption tax base by exempting from tax income saved, the treatment of interest expense becomes a critical consideration. The response under existing law, as previously outlined, is incomplete and has not been comprehensively or consistently rationalized.

With respect to owner-occupied housing, present law reflects an extremely strong social policy to encourage home ownership. The deduction of home mortgage interest fosters this policy by making the full benefit of the exemption from tax of the value of the use of such an investment available generally without regard to the extent to which the taxpayer has other assets. The taxpayer enjoys the same benefit whether his taxable income consists solely of wages or income from investment assets. If the interest were disallowed, only the taxpayer with investment assets could avoid the effects by converting such investment assets into an investment in such housing. The interest deduction allows every potential homeowner with wage or investment income an equivalent opportunity to cash-out the benefits of the exemption from tax of the returns from owner-occupied housing.

This analysis reflects the critical equity and economic considerations that must be weighed. Denial of the interest deduction rather than taxing the excluded income from the asset in question builds in a fundamental inequity. The taxpayer with investment assets can substitute the tax-free return on the asset in question for taxable return on his investment assets, with no net tax effect. The taxpayer without investment assets to liquidate cannot do so and suffers a net tax increase.

The economic considerations involved are beyond the scope of this paper but must be carefully evaluated. As previously stated (pp. 4-5, 20-21), the effect of the denial of an interest deduction on the availability and value of various classes of assets, and on growth in GNP, cannot simply be resolved by transition rules.

All factors considered, it seems evident that the strong social policy favoring home ownership together with the equity considerations, and possibly the economic considerations, dictate against denial of the interest deduction with respect to a mortgage on the taxpayer's principal residence. This same policy, however, does not so clearly support ownership of secondary residences. Economic [33] and administra-

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[30] See Treasury Report, pp. 195, 332-333.

[31] See, for example, Rev. Proc. 72-18, 1972-1 C.B. 740, sec. 4.02, 4.03; compare Proposed Reg. § 1.57-2(b)(iii)(a).

[32] See footnote 18, supra.

[33] See supra, pp. 4-5, 20-21.

tive [34] considerations call for exempting some additional amount of interest from the limitation, and the Treasury proposal of $5000 seems to be a reasonable level. The Bradley-Gephardt proposal both to deny all non-business interest in excess of investment income, except all interest related to owner-occupied housing, whether or not the taxpayer's principal residence, and then to substitute a credit, in effect, for the interest deduction that is allowable,[35] seems particularly ill-conceived. The policies supporting these various cross-effects seem impossible to rationalize.

As for non-business borrowing for investment in assets other than housing or consumer purchases, a major source of the tax arbitrage problem with respect to investment income, the realization requirement, will continue to exist. Annual or periodic valuation of assets to record gains and losses will remain impractical. This necessitates some limitation on the deduction of non-business interest, though one more effective and administrable than § 163(d). Ideally, as under the alternative minimum tax, all non-business interest should be made non-deductible except to the extent of taxable investment income and except as to interest specifically carved out (personal residence interest plus $5000).

This formulation avoids the uncertainty of correlating debts and related assets; there would no longer be any need to apply the test whether the debt was incurred or continued to purchase or carry the asset in question, even as to tax-exempt interest. As suggested by the Treasury proposals,[36] increased attention should also be given to distinguishing between business interest and non-business interest for these purposes. Borrowing in a sole proprietorship, partnership, or Subchapter S corporation, where the proceeds are not directly reinvested in active business operations or assets needed for the business, as opposed to investment assets, should invite scrutiny.

CONCLUSION

The case for denying a deduction for non-business interest is an uneasy one, involving difficult equity and economic considerations.[37] The problem in the U.S. tax system is in the failure to adhere to a comprehensive tax base. Denial of non-business interest is an imperfect adjustment to respond to such failures. Even so, it is justified to some degree because of the practical inability to tax all sources of real income. To the extent the deduction of non-business interest is denied, it should be accomplished by arbitrary rules that provide certainty without undue complexity, a standard which the rules of existing law denying such a deduction do not satisfy.

KRONISH, LIEB, SHAINSWIT, WEINER & HELLMAN,
New York, NY, June 20, 1985,

Congressman J.J. PICKLE,
Chairman, Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, Washington, DC.

DEAR CONGRESSMAN PICKLE: The following is a question-by-question breakdown of my responses to your letter to me of May 13, 1985:

1. Tax law doesn't encourage mergers, only the form of the acquisition. Tax law should, if possible, be neutral as to corporate acquisitions. The Senate Finance Committee Staff Proposal on the Subchapter C Revision Act (May, 1985) is an attempt to reach neutrality as to acquisition forms, and I support its basic approach.

2. Yes. Other tax characteristics which would make a corporation attractive to a takeover also include tax loss carryovers (and tax credit carryovers) and high basis assets.

3. (a) Tax law clearly encourages debt financing.

(b) No to the first three, maybe to the fourth, but the real problem here is the tax disparity between debt and equity which would be cured by corporate-shareholder integration. Also, excessive leverage is a major concern; perhaps expanding the scope of § 279 is a reasonable approach. Other alternatives would be to impose limitations on the order of § 163(d) (the investment interest rules), or to extend § 246A

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[34] See supra, pp. 24-25.
[35] See footnote 2, supra.
[36] See footnote 1, supra.

to "control" stock acquisitions as well as "portfolio" stock acquisitions (i.e., deny the dividends received deduction to the extent the acquisition is debt-financed). Finally, the interest deduction also might be denied if the holder is tax-exempt (i.e., a § 501, § 401, or foreign holder). This would cure the mis-match problem of present law.

4. Not sure here; the "independent director" test probably shouldn't be conclusive (only presumptive, at most). On the whole, however, I don't think the tax law should (or can) reasonably distinguish between "friendly" and "hostile" acquisitions.

5. (a) No.

(b) No.

(c) Maybe, if the leverage becomes "excessive," wherever that line is drawn.

(d) No. The question is whether they are true debt; if they are, then interest should be deductible (subject to the possible restrictions mentioned in question 3(b), supra).

6. If the Treasury couldn't define debt in over 14 years of trying to draft regulations under § 385, I doubt if I can do so at this point under present time constraints. Excessive leverage is the root problem here, though, as is the tax law's bias in favor of debt over equity financing.

7. The ⟨338 election doesn't cause mergers to happen, but probably does influence the form of the merger (though I'm not even too sure of this).

8. Don't know.

9. I generally support the approach of the Sub-chapter C Revision Project (May, 1985), which repeals ⟨⟨336 and 337, if cost basis treatment is elected, but gives limited shareholder-level relief from double tax consequences in the case of "small business".

10. Generally agree; I favor the ABA Tax Section approach, although I could live with the Finance Committee Staff proposal.

11. Through the securities laws; golden "parachutes" are bad enough. I would oppose the "greening" of the tax code to reach these transactions, which are even harder to define than golden parachutes. Repeal of the capital gain preference would solve this problem, if there is one here.

12. No (I don't believe they can under current law, but an amendment to ⟨263 would put an end to any conceivable argument here).

I'm sorry that time pressures prevented a more extensive response to the above, but I believe that these comments represent the essence of my views on this subject.

Very truly yours,

JAMES S. EUSTICE

Chairman PICKLE. Thank you very much. Thank you, gentlemen. This whole problem is complex and probably as difficult to fashion a solution to as almost any matter I could imagine.

We'd like it to be understood though that this committee is not going to sit back and do nothing. To do that I think would see these things grow and get larger and larger. Eventually they will correct themselves if you have a big recession or depression, then that might stop it, but that would sure be the hard way to do it.

I think we are beginning to see a few things we can do without trying to write a new Magna Carta, which some of the people seem to think we might be attempting. I am confident we can do it.

I think the hearing today and this is the third one, has given us a lot of information and from that I think then we can consider making some recommendations to the full committee.

So, we do thank you. Your testimony has been very helpful.

The committee will stand adjourned.

[Whereupon the hearing was adjourned.]

[Submissions for the record follow:]

FEDERAL HOME LOAN BANK BOARD,
Washington, DC, May 20, 1985.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, DC.

DEAR MR. CHAIRMAN: Your recent subcommittee hearings on tax aspects of mergers and acquisitions focused chiefly on transactions in which Federal income tax

benefits are a principal driving force. In contrast to "tax motivated" mergers, I would like to call your attention to a different and more positive role which tax rules play in assisting government-supervised mergers of insolvent savings and loan associations ("S&Ls"). These mergers occur under the supervisory authority of the Federal Home Loan Bank Board ("Bank Board" or "Board") and the Federal Savings and Loan Insurance Corporation ("FSLIC") to safeguard and maintain the federal deposit insurance program. Tax benefits are not the primary reason for these mergers. This program has long protected savings and loan institutions and, most importantly, the funds which depositors have placed in those institutions. The Bank Board believes that it is crucial to the viability of the FSLIC, and the overall health of our economy, that any tax reform retain the existing tax provisions which facilitate these supervisory mergers.

The Economic Recovery Tax Act of 1981 ("ERTA") adopted several statutory provisions which address the taxfree reorganization of troubled thrifts, clarify loss carryover rules, exclude from income financial assistance supplied by FSLIC to weakened thrifts, and liberalize the rules concerning the effect on asset basis when FSLIC contributes to the capital of a weakened institution.[1]

In its tax reform plan the Treasury Department proposes to repeal these ERTA provisions. It regards the rules as "subsidies," and says the provisions tax thrift institutions and their shareholders differently from other business enterprises, and shift some of the burden of thrift losses to the Federal government. The Treasury claims that federal aid provided through the special tax rules "is likely to exceed the amount of assistance that would otherwise be provided through direct appropriations."

The Bank Board disagrees strongly with this analysis and believes the Treasury's proposal would be short-sighted and have severe adverse effects on the public interest, now and in the future.

I am sympathetic to your desire to assure that the provisions of the Internal Revenue Code reflect sound public policy. There is nothing in the tax rules which facilitate supervisory mergers contrary to that goal. A limitation or repeal of the provisions, however, would have extremely adverse effects on the ability of the Bank Board, as the operating head of FSLIC, to resolve the severe difficulties facing the thrift industry, and to operate at maximum efficiency in the future.

1. IMPORTANCE OF EXISTING TAX PROVISIONS

The current tax treatment afforded thrift supervisory mergers and contributions by FSLIC to assist weakened institutions provides a highly cost-effective means for avoiding otherwise unnecessary liquidations of thrifts, reducing the current pressure on FSLIC's financial resources, and protecting depositors in FSLIC-insured institutions. At the same time, the existing tax treatment has not, to our knowledge, been abused in any way.

Taxfree treatment of a supervisory merger means that a healthy institution which assumes the assets and liabilities of a savings institution in default, or in danger of default, will not encounter unexpected tax penalties. That is, the acquirer will not find that the acquired institution must suddenly recapture its prior bad debt reserve deductions, or find its past tax history cut off, or find that, when the acquirer collects the mortgage receivables taken over in the merger, it will realize unexpected taxable income.[2] Taxfree treatment prevents all these tax penalties for the sensible reason that the underlying circumstances do not call for the tax law to create obstacles to this type of reorganization. If these negative tax results were to occur, FSLIC would find either that no healthy institution would be willing to acquire the insolvent association, or the acquirer would request the FSLIC fund to reimburse the acquirer for all the negative tax results. Either of these consequences would prevent the Board from carrying out its responsibilities in an effective, efficient manner.

The tax treatment of a supervisory merger and of FSLIC assistance to such a merger are factors which FSLIC must calculate into its ultimate cost of assisting a

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[1] Section 368(a)(3)(D)(ii) of the Internal Revenue Code deals with supervisory thrift mergers. Section 597 deals with the tax treatment of FSLIC financial assistance and Section 593(e) deals with repayment by an institution of FSLIC assistance. Section 382(b)(7)(B) treats depositors as shareholders for purposes of applying net operating loss carryover limitations to supervisory thrift mergers.

[2] "Discount income," so-called, would arise if the merger were taxable, because the tax basis of the mortgages would be reduced to current market value. Collections on the mortgages would then be transformed into taxable income when collections exceed the decreased tax basis of the mortgages.

merger. The cost of FSLIC assistance in a particular case may not—under 12 U.S.C. § 1729(f)(4)(A)—exceed the cost of a liquidating payout of insurance. Because of this provision, a failing thrift would have to be liquidated in a case where the cost of assistance would exceed the payment of insurance on all accounts. The tax treatment under ERTA, however, helps us avert the need for otherwise unavoidable liquidations by fostering supervisory mergers of failing thrifts. The cost to FSLIC of paying insurance if no acquirer can be found because of tax detriments would in many, if not most, cases exceed the "cost" to the Treasury of allowing the mergers to receive taxfree treatment. In this respect I disagree strongly with the Treasury's statements in its tax proposals. Allowing taxfree treatment is really not a "cost" to the Treasury at all, because the policy of taxfree treatment of supervisory mergers is consistent with the fundamental policies allowing taxfree reorganizations generally.

Legislative policy in ERTA. The legislative history of ERTA also provides abundant evidence that Congress recognized that encouraging assisted thrift mergers and capital infusions to avoid liquidating payouts was of paramount public interest. Senator Boschwitz's statement on the Senate floor introducing the ERTA amendments affecting thrift assistance clearly illustrates this Congressional intent:

"This amendment would facilitate the infusion of capital to a failing savings and loan or the merger of a savings and loan with another financial institution by clarifying that these transactions are nontaxable events.

"The other alternative to capital infusions or mergers in the case of a troubled savings and loan would be liquidation by the Federal Savings and Loan Insurance Corporation. This would require payment out of their insurance funds to all insured depositors and would have unfortunate results for non-insured depositors. The potential cost to the Government, depositors, and shareholders could be significant. * * *

"Under current law, there is some uncertainty about the consequences of capital infusions to savings and loans or mergers of savings and loans. This uncertainty deters potential investors and will likely result in the more costly liquidation payouts by the FSLIC."

* * * * * * *

"(S)urely a merger of a failing savings and loan serves the public interest better than liquidation." [3]

II. CURRENT ECONOMIC CONDITIONS

With regard to the industry's current condition, I must emphasize the magnitude of the task facing FSLIC. Recent rate declines have reduced the negative "spread" between the industry's cost of funds and yield on assets, which accounted for the record losses experienced by the industry in 1981 and 1982. The crisis, however, is by no means over, and FSLIC's need for maximum cost efficiencies continues. The cumulative impact of several years of record losses has seriously eroded the capital base of the industry and has left many associations so weakened that they will continue to deteriorate regardless of further positive economic developments.

Although thrift institutions significantly increased their already large contribution to housing markets during 1984, developments during last year demonstrated the fragility of the industry's recovery, and its vulnerability to interest rate changes during the lengthy period required to restructure thrifts' balance sheets. In recent years, we have also seen the beginnings of a disturbing trend in the reasons why failing savings institutions fall onto FSLIC's doorstep. Three years ago, approximately 80% of FSLIC cases were primarily attributable to interest rate spread problems, and 20 percent were primarily due to asset quality problems. For 1984, that ratio reversed itself to 30–70—with the result that a substantial portion of the FSLIC's caseload is characterized by bad assets. I cannot overemphasize the importance of this shift to FSLIC's problems. Asset quality cases have proven to be up to five times as expensive for FSLIC as interest rate spread failures.

Savings and loan managers are still in the early stages of restructuring their portfolios to avoid the huge maturity mismatches which nearly drove the industry to disaster in 1981–1982. The health of the industry over the past two years has shown relative improvement over the previous two-year period, but this improvement is primarily the result of falling interest rates and certain accounting devices which exaggerated actual operating profits.

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[3] 12 Cong. Record, S8288, (1981).

In 1984 FSLIC-insured institutions had net income after taxes (exclusive of a special preferred stock dividend paid by the Federal Home Loan Mortgage Corporation) of approximately $1.1 biilion.[4] This is substantially less than the $2.0 billion income in 1983. It represents a return on assets of approximately 0.12%, compared to 0.27% in 1983.[5] This is still, of course, sharply better than the operating picture in 1981-1982, but well below the level of profitability prevailing in the late 1970s, when the industry was considered, by relative measurements, at the peak of health.

Economic developments during 1984 also point up the industry's continuing vulnerability to changes in interest rates. The annualized return on assets declined from 0.23 percent in the last half of 1983 to 0.16 percent in the first quarter of 1984 and to a meager 0.05 percent in the third quarter of 1984.

Despite the overall profitability of the thrift industry last year, 25 percent of all FSLIC-insured institutions were operating in the red for the year 1984 as a whole. The ratio of regulatory net worth to total assets edged downward from 4.03 percent at the end of 1983 to 3.88 percent at the end of December, 1984. And 29 percent of the industry had a ratio of regulatory net worth to total assets of less than 3 percent.

FSLIC's reserves protect a deposit base that stood at more than $785 billion at the end of last year. By contrast, the book value of the FSLIC's reserves declined from $6.4 billion as of December 31, 1983 to slightly less than $6.0 billion as of March, 1985. This was the first time in its history that FSLIC book reserves actually declined. This decrease results from the increased demand placed on the Fund stemming from a growing number of asset quality problems at some FSLIC-insured institutions. Since December 31, 1982, almost all income received by the FSLIC has been expended to solve problem cases.

The ratio of FSLIC's reserves to insured deposits has also been at or near an historic low point. Historically, the reserve ratio (total FSLIC book reserves as a percentage of total deposits) has averaged 1.2%, peaking at 2.12% in 1970. Since then, the ratio has decreased sharply, falling from 0.92% at the end of the third quarter of 1984 to 0.76% at year end.

Of the 27 cases resolved by FSLIC during 1984, 19 were asset quality problems and only 8 were interest rate spread problems. These asset quality cases are more complex and significantly more expensive to resolve. This is especially true because, in recent months, potential acquirers of severely troubled institutions have not come forward. Potential acquirers have tended to be unwilling, for the most part, to assume the risk of large losses on bad assets. Also, potential acquirers which might otherwise have had a serious interest in gaining interstate franchise rights through supervisory mergers are now applying for, and receiving, "nonbank bank" franchises in many states—this tends to reduce our pool of possible acquirers having a real interest in, or incentive for, helping FSLIC resolve its problem cases through acquisitions.

Nevertheless, FSLIC increased its efforts during 1984 to prevent thrift institution defaults. FSLIC processed 27 cases in 1984 with assets of $5.88 billion and a net present value cost of approximately $700 million. This included resolving 18 cases with assets of $4.3 billion through the assisted acquisition process. FSLIC also placed 9 institutions with assets of $1.5 billion in receivership. The cost to pay insurance on these cases is estimated to be $450 million. (Before 1983, the total number of institutions liquidated by the FSLIC throughout its entire 50-year history was only 15).

In our current budget, FSLIC estimates that its cost for assisted mergers will increase from $801 million in 1984 to $1.9 billion in 1985 and to $2.3 billion in 1986.

Given this current state of the industry, the policies underlying the existing tax treatment of supervisory mergers and FSLIC assistance remain compelling. Indeed, because the industry's condition has deteriorated since the enactment of ERTA, its reforms are more justified and necessary today than they were in 1981. FSLIC anticipates that it must now provide greater financial assistance than in the past to induce stronger or healthy institutions to acquire those which have been weakened.

III. TECHNICAL TAX FACTORS

A large part of the ERTA reforms in 1981 did not represent "favorable" treatment of thrifts, but were necessary technical refinements of the "G" reorganization,

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[4] Figures represent actual data for the first three quarters of 1984 and estimated amounts for the fourth quarter.

[5] Even including the $0.6 billion extraordinary Freddie Mac stock dividend, net income in 1984 is estimated at only $1.7 billion (0.19% return on assets), still well below the 1983 level.

which was enacted in 1980 without specifically considering the unique features of mutual and stock savings and loan associations.

The tax provisions adopted in 1981 are well within the basic policies which justify taxfree treatment of reorganizations and taxfree treatment of contributions to corporations generally. Perhaps the principal tax issue which concerns the Treasury in a supervisory merger arises where an acquiring institution which is a stock association acquires the mortgages and customer deposits of a weakened association and substitutes equivalent deposit accounts in the acquiring institution, but without issuing any stock to the depositors. Shareholders, if any, of the insolvent institution usually receive no consideration from the acquirer. The Treasury seems concerned that this exchange violates the so-called continuity of interest principle, which might seem to require receipt of stock or other type of equity interest in the acquiring institution. Failure to satisfy this requirement led to a denial of taxfree treatment in a recent Supreme Court decision, *Paulsen* v. *Commissioner*, 53 U.S.L.W. 4029 (U.S. Jan. 8, 1985), (stock in solvent thrift transferred in exchange for deposit accounts).

Supervisory mergers, however, are significantly different from these types of acquisitions. Where the transferor association is basically insolvent, its depositors become its economic owners and supplant the actual shareholders, if any. The equity rights held by depositors in a mutual S&L are minimal; yet the Internal Revenue Service has ruled that a merger of one healthy mutual S&L into another mutual S&L is taxfree (Rev. Rul. 69-3 1969-1 C.B. 103). A supervisory merger of an insolvent thrift (stock or mutual) into a stock association which assumes the depositors' account does not differ economically from a mutual-to-mutual merger. In both cases the "equity" aspects of the depositors' accounts are, in fact, minimal. I believe the similarities are sufficient to justify treating a supervisory merger—where depositors have essentially acquired all remaining interest in the weakened institution—as within the basic reorganization policies.

By their nature, supervisory thrift mergers do not present significant problems with respect to "tax motivated" takeovers or trafficking in loss companies. The current rules regarding continuity of interest and net operating loss carryovers apply only in cases where the Bank Board certifies that the institution to be reorganized is insolvent, has experienced a substantial dissipation of assets or earnings, or is in an unsafe or unsound condition to transact business. In our experience over four years, these provisions have worked well and have not been abused. We at the Bank Board have been aware of the need to follow the tax requirements conscientiously. We have applied our certification authority responsibly.

It is also important to point out that financial assistance agreements are structured so that FSLIC, not the weakened thrift or its acquirer, obtains the benefit of tax savings produced by net operating loss carryovers or loss deductions attributable to assets of the merged institution. FSLIC obtains this benefit by means of provisions which credit the tax savings to FSLIC and, in effect, reduce the amount of financial assistance which FSLIC is obligated to provide.

IV. SUMMARY

In the Bank Board's view, repeal of the ERTA reforms for thrifts would cripple FSLIC's ability to resolve the large problems still facing the industry and would eliminate significant benefits to the public resulting from FSLIC's protection of insured and uninsured depositors. Supervisory mergers are crucial to the health of the financial services industry and to the continued confidence of depositors in the entire banking system. Such confidence benefits the entire national economy.

Please contact me, or any of my staff, if we may be of any further assistance to you on this matter of continuing importance to the financial industry.

Sincerely,

EDWIN J. GRAY, *Chairman.*

STATEMENT OF JOHN P. MASCOTTE, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, THE CONTINENTAL CORP.

Chairman Pickle, Chairman Rangel, other distinguished members, I appreciate the opportunity to offer these comments on behalf of The Continental Corporation, one of America's largest independent property-casualty (p-c) insurers.

I would like to bring to your attention those provisions of the Internal Revenue Code considered in the takeover of a p-c company—the consolidated return provisions of the Code and the deemed asset purchase provision of the Code (i.e. Section 338).

A p-c company generates large tax losses which often exceed its economic losses. This phenomenon is a function of state regulatory accounting adopted by the tax law and the exemptions offered by the Code to all p-c companies. Under state regulatory accounting, a p-c company defers income receipts and deducts immediately the expenses in earning that income; in addition, a p-c company deducts in advance its estimate of losses incurred and its estimate of what settlement expenses will be. In this connection, a p-c company also has the option of investing its reserves for unearned income, losses and expenses in securities which yield tax sheltered income, i.e., tax exempt bonds and stocks.

The tax accounting rules for p-c companies have as their underlying purpose the preservation of the solvency of p-c companies which, incidentally, is also the state regulatory purpose. In this manner, the interests of all policyholders is protected, moreover, the Treasury is protected as long as other parties cannot avail themselves of the p-c statutory accounting rules to utilize otherwise unutilized tax losses.

The delicate balance between protecting policyholders and the Treasury is destroyed when others can avail themselves of the tax accounting rules applicable to p-c companies. This can occur when a non p-c company acquires a p-c company and files consolidated returns to utilize its losses, losses that a non p-c company could not otherwise generate as under state law it cannot operate a p-c business directly. Indeed, the non p-c company will pay for the future tax benefits to be generated from the target p-c company. These tax benefits can be multiplied if a Section 338 election is made with respect to the target p-c company.

A Section 338 election can multiply the tax benefits of the target p-c company because the economic profit inherent in the existing reserves of the p-c company can be turned into a tax deduction even though a substantial portion of that economic profit may be attributable to future tax sheltered income. Just for one large acquisition the loss to the Treasury over a period of time on account of the consolidation and Section 338 election rules can amount to several hundred million dollars.

The obvious tax incentives in acquiring a p-c company can lead to acquisitions that are not economic. The acquisition history of Baldwin-United and its ultimate downfall is a case in point. Other acquisitions where the tax rules played an important role are well documented and are a matter of public record. Indeed, today more than one half of the largest p-c underwriters are owned by non p-c companies. See Exhibit 1. An interim Treasury study due in July of 1986 will demonstrate how badly the fisc is effected just by consolidation with life companies. When one considers the benefits non insurance companies obtain under the consolidation—Section 338 rules, it is apparent that corrective legislation eliminating these rules is necessary.

EXHIBIT 1

The following list illustrates the consolidated groups which are affiliated with more than half of the 25 largest p-c insurers:

1. State Farm [affiliated with State Farm Life].
2. Allstate [owned by Sears, Roebuck, affiliated with Allstate Life].
3. Aetna Casualty & Surety [affiliated with Aetna Life].
4. CIGNA [the company created by the acquisition of INA by Connecticut General Life in 1982].
5. Travelers [affiliated with Travelers Life].
6. Farmers [independent].
7. Continental [independent]
8. Liberty Mutual [independent].
9. Hartford Fire [owned by ITT].
10. Fireman's Fund [owned by American Express, affiliated with IDS Life].
11. Nationwide [affiliated with Nationwide Life].
12. U.S.F & G [independent].
13. Crum & Forster [bought by Xerox in 1983].
14. Kemper [independent].
15. Home [owned by City Investing].
16. St. Paul [independent].
17. AIG [independent].
18. Commercial Union [independent].
19. CNA [owned by Loews and affiliated with CNA life companies].
20. Royal [independent].
21. Chubb [independent].
22. USAA [independent].
23. Prudential [owned by Prudential Life].

24. American Financial [an insurance holding company with both life and property-casualty subsidiaries].
25. Reliance [bought by Leasco, now Reliance Group].

STATEMENT OF HON. WILLIAM J. COYNE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Mr. Chairman, it is a long way from Pittsburgh, Pennsylvania to Bartlesville, Oklahoma, but recent attempts at corporate takeovers and mergers brought these two cities together in a very real way.

In the case of Bartlesville, a takeover attempt of Phillips Petroleum would have meant the virtual dismantlement of that town's economic base.

In the case of my city of Pittsburgh, a takeover of Gulf Oil by Standard Oil of California (SOCAL) raises the serious possibility of an erosion of the local tax base and the loss of hundreds of jobs.

When it became know that SOCAL was going to absorb Gulf of Pittsburgh, much of the press speculation focused on the winners and losers in the deal. Certain stockholders were big winners. So were most of the corporate executives involved.

Who were the losers? I can tell you with certainty that the City of Pittsburgh, once the home to Gulf Oil, stands to be the big loser in this merger. Where once there were two companies, there now remains only one, and it will have its headquarters in California. Pittsburgh will likely lose up to 1,800 Gulf employees. This robs the local economy of $75 million in wages and salaries during a period in which area unemployment remains high. This will mean a loss of between $300,000 and $500,000 in local wage taxes contributed by Gulf employees–this from a city wage tax revenue of $57 million.

The absorption of Gulf by SOCAL will harm Pittsburgh in other ways as well. Gulf contributed more than $360,000 to the local United Way in 1983. At least 50 charitable organizations received over $2 million in contributions from the corporation in that year. The local public television station received $4 million from Gulf to produce a widely acclaimed series. When Gulf leaves the area, so will those contributions.

There is already a considerable body of law which governs corporate takeovers and mergers from an anti-trust viewpoint, thus protecting the consumer, in theory, from adverse consequences associated with the merger of one company with another. I found nothing in my research of existing law at the time of the SOCAL-Gulf merger, however, which protected a community from adverse consequences as a result of a merger.

As a result, I introduced the Corporate Community Investment and Jobs Preservation Act in the last Congress. This legislation, which I have reintroduced in the 99th Congress, would broaden the federal responsibility in merger regulation to include a review of the impact of a merger on a local economy.

The Corporate Community Investment and Jobs Preservation Act of 1985 (H.R. 960) requires large corporations planning to merger to file a community impact statement with the Federal Trade Commission (FTC). This statement would describe the economic and social impact a merger could be expected to have on the communities involved. If the FTC determines that impact to be adverse, the corporation which borrows money to finance the takeover would be denied a tax deduction for interest incurred on indebtedness related to the acquisition.

The legislation establishes a three-step process for those large corporations which, under the Hart-Scott-Rodino Act of 1976, are required to file a premerger notification with the FTC and the Anti-Trust Division of the Justice Department. This includes acquired companies with sales or assets in excess of $10 million and acquiring companies with sales or assets in excess of $100 million.

In the first step, corporations must file a community impact statement with the FTC if the merger can be expected to eliminate more than one hundred jobs in a particular locality. The statement would describe the business where the employment will be reduced and would give the reasons for the reduction. The statement would also be required to contain a plan to minimize the effect of the employee reduction on the community involved. It would also describe the economic status of the corporation in which the jobs would be eliminated, including the level of profitability and plans for future investment, employment and production. In addition, the FTC, the community impact statement would be made available to the Justice Department, employees of the corporations involved, and to the local governments in which the corporations are located.

Second, after the Community Impact Statement is filed, employees of the corporations and the local governments may petition the FTC to hold public hearings so that facts included in the statement can be investigated. In the course of hearing testimony from local public officials and others, the Commission would study the economic rationale for any employee reduction described in the statement and would estimate the extent of economic loss to the employees and the communities.

Third, once the investigation is concluded, the FTC would prepare a report on the findings and make a recommendation as to whether legal action should begin to halt the merger. If the FTC finds the merger will have a substantial adverse impact on employment in a particular locality, the tax deduction for interest incurred by one corporation to acquire another would not be allowed.

Loss of ability to deduct interest on acquisition debt would, I believe, lessen the chance that a merger would go ahead. This would protect communities from suffering the job loss that results from certain mergers. This would also protect the fiscal interest of another big loser in corporate merger mania. That is, of course, the federal government, which loses tax revenue when corporations can deduct from their taxes the amount of money used to pay interest on money borrowed to acquire another corporation.

Last year, I asked the Congressional Research Service to estimate the Treasury's loss on a dollar of debt used to finance a merger. By way of explanation, most mergers are financed by a combination of short-term debt and equity, using a line of credit from major banks at a prime rate. With a prime rate of 11 per cent as a basis, one year's financing would generate and interest payment of $0.11 per dollar of debt. The Congressional Research Service estimates that a 2-year line of credit in this instance would mean a revenue loss of $0.1012 per dollar of loan. This means, of course, a revenue loss of more than $101,000 on a loan of $1 million. The revenue drain from a deal on the scale of the SOCAL-Gulf merger could mean the loss of hundreds of millions to the Treasury. A debt-financed $13.5 billion takeover would mean the loss of $1.356 billion to the Treasury over two years if it were financed in the same way as this example.

This reduction in revenue to the Federal Treasury could result from just one merger between two companies. As we are all aware, there were many large mergers last year which, without a doubt, meant the loss of additional dollars to the Treasury. In effect, the federal government subsidizes mergers, thus depriving itself of much-needed revenue, even when such mergers may have an adverse affect on a local economy.

To help illustrate the magnitude of the problem, I would like to include in the Record a listing of the billion-dollar mergers of 1984:

BILLION-DOLLAR MERGERS IN 1984

Buyer	Seller	Transaction type	Value (billions)
Chevron Corp	Gulf Corp	Acquisition	$13.40
Texaco Inc	Getty Oil Co		10.12
Mobil Corp	Superior Oil Co		5.70
Kiewit-Murdoch Inv. Corp	Continental Group Inc		2.75
Beatrice Cos	Esmark Inc		2.71
General Motors Corp	Elec. Data Systems Corp		2.60
Broken Hill Proprietary Co	General Electric Co. (Utah International unit).	Divestiture	2.40
Champion Intl. Corp	St. Regis Corp	Acquisition	1.83
Phillips Petroleum Co	R.J. Reynolds Inc. (energy operations)	Divestiture	1.70
Manufacturers Hanover Corp	RCA Corp. (C.I.T. Financial unit)		1.51
Dun & Bradstreet Corp	A.C. Nielsen Co	Acquisition	1.34
Intl Business Machines Corp	ROLM Corp		1.26
Pace Industries	City Investing (various subsidiaries)	Divestiture	1.25
American General Corp	Gulf United Corp. (insurance operations)		1.20
American Stores Co	Jewel Cos	Acquisition	1.15
J.W.K. Acquisition Corp	Metromedia Inc	Leveraged Buyout	1.13
General Electric Co	Employers Reinsurance Corp	Acquisition	1.075
Texas Eastern Corp	Petrolane Inc	Acquisition	1.04

Source: Mergers and Acquisitions, Philadelphia, Washington Post.

The purpose of the Corporate Community Investment and Jobs Preservation Act is to bring the federal government into the modern era when it comes to corporate mergers. We can no longer rely on laws rooted in the economic conditions of the 1890s, when Congress laid the cornerstone for today's anti-trust legislation, to address the complex economic issues now raised by mergers between giant corporations.

Corporate capital today moves with the speed of an electronic funds transfer. The human capital of a city, embodied in the people who live, work and pay taxes in a municipality, is far less mobile. When a corporate merger causes the shutdown of one corporate headquarters or another, hundreds of jobs can be lost. Cities see their tax base shrink even as the demand for services rises as a result of increased unemployment.

When this happens, we cannot simply ask the question: "Is this in the corporate interest?" We must be ready to ask: "Is this in the public interest?" And we must be ready to look beyond whether a merger is harmful to the economy in general. We must determine whether it has an adverse impact on cities in particular.

Under my legislation, if, after the filing of a community impact statement and public hearings, it is determined that a merger is in the public interest, it will be allowed to go ahead. If it is not in the public interest, the federal government would have no role in the indirect financing of a merger which eliminates jobs or dismantles communities.

The recent merger wave indicates a new way of doing business at the corporate level. I believe it is time for the federal government to move with the times and adopt a new way of regulating corporate mergers. The Corporate Community Investment and Jobs Preservation Act is a step in that direction. By allowing local residents to be heard at public hearings on the community impact of a planned merger, the legislation continues a worthwhile trend toward a public/private partnership.

At this point, I would like to include in the Record two pertinent pieces of material. The first is an Associated Press story which describes the proposed sale of the Gulf building in Pittsburgh. Following that is the text of the Corporate Community Investment and Jobs Preservation Act of 1985.

GULF'S HEADQUARTERS FOR SALE

PITTSBURGH LANDMARK AVAILABLE FOR $40 MILLION

PITTSBURGH.—Gulf Oil Corp., which is moving its headquarters to San Francisco as a result of its $13.3 billion buyout last year by Chevron Corp., said this week it's offering its pyramid-capped headquarters for sale for $40 million.

The city landmark, with its art deco architecture and rooftop weather beacon, has served as Gulf's corporate headquarters for more than half a century.

"While the building may not look new compared to today's skyscrapers, it operates as efficiently as most new buildings," said Richard A. Flinn, director of divestments for Gulf.

The company spent more than $16.5 million over the past 12 years to modernize and update the structure, Flinn said. The exterior of the building was cleaned, repointed and sealed with silicone in 1982.

Brochures advertising the 44-story building's private health spa, dining facilities and executive suites are being distributed throughout the nation, informing prospective buyers that Gulf is accepting all inquiries and bids on the 53-year-old downtown structure, Flinn said.

"We plan to begin a major nationwide advertising campaign to sell the building," he said. "That campaign should be ready in about two weeks."

About 650 people are now working in the building. The structure's current layout could accommodate about 1,200 employees.

Since the Chevron acquisition, Flinn said he's received 60 to 70 inquiries or bids on the building from both local and national sources.

If the building is sold prior to the completion of the Gulf-Chevron merger activities, Gulf would lease space or move, Flinn said. The two companies are awaiting final approval of their merger from the Federal Trade Commission.

A Bill to require community impact statements by certain corporations involved in mergers which will result in reducing the number of persons employed in any community by at least one hundred individuals, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Corporate Community Investment and Jobs Preservation Act of 1985".

SEC. 2. If two or more corporations propose to merge, if with respect to such merger such corporations are required to file a notification under section 7A of the Act of October 15, 1914 (15 U.S.C. 18a) (commonly referred to as the "Clayton Act"), and if the merger may be reasonably expected to reduce the number of employees employed in an establishment of such a corporation in the county, city, or other jurisdiction in which the establishment is located by more than one hundred employees, each corporation to be involved in the proposed merger shall file, in accordance with section 2, a community impact statement. A community impact statement shall include—

(1) the nature of the business of the establishment of the corporation at which the reduction of employees will take place,

(2) the reasons for such reduction,

(3) any alternative to such reduction,

(4) a plan to minimize the effects of such reduction on the remaining employees in such establishment and on any unit of general local government having jurisdiction over the area in which such reduction will take place,

(5) the economic circumstances of such corporation including the level of profitability of the operation at the establishment of such corporation at which the reduction in employment will take place and any plan for future investments, employment, and production at such establishment, and

(6) the number of employees who will lose their employment as a result of the merger.

SEC. 3. The community impact statement required by the first section shall be submitted to the Federal Trade Commission, the Department of Justice, to the employees and representatives of each labor organization representing such employees at each corporation involved in the merger, and to each unit of general local government having jurisdiction over an area in which establishment of such corporation is located. The statement shall be filed on the same date a notification respecting the merger is filed under section 7A of the Act of October 15, 1914.

SEC. 4. If, within fourteen days of the submittal of a community impact statement under section 3, the Federal Trade Commission receives a request by a unit of local government which has received the community impact statement or by at least 10 per centum of the employees of a corporation which filed such statement, the Commission shall conduct an investigation into, and hold public hearings on, the community impact statement. Such an investigation shall include—

(1) the economic reasons for the proposed reduction in employment described in the statement,

(2) the estimated extent of the economic losses to the employees employed in the establishment in which such reduction will occur, including the number of employees who will lose their employment as a result of the merger,

(3) the estimated extent of any economic loss, including a decline in the tax base, of any unit of general local government having jurisdiction over such establishment and any economic loss to any person in the geographic area in which such establishment is located, and

(4) the recommendations of any such unit of local government, any labor union representing employees in each corporation to be involved in the proposed merger, or any other person respecting the proposed merger.

SEC. 5. After an investigation is concluded under section 4, the Federal Trade Commission shall prepare and publish a report containing the findings of the investigation and recommendations as to whether or not legal action should be taken to halt such merger.

SEC. 6. Section 279 of the Internal Revenue Code of 1954 (relating to interest on indebtedness incurred by a corporation to acquire stock or assets of another corporation) is amended by adding at the end thereof the following new subsection:

"(k) SPECIAL RULE FOR OBLIGATIONS ISSUED FOR CORPORATE MERGERS ADVERSELY AFFECTING EMPLOYMENT.—

"(1) IN GENERAL.—Subsection (b) shall not apply to any obligation issued in connection with a corporate merger with respect to which the Federal Trade Commission has made a finding described in paragraph (2).

"(2) FEDERAL TRADE COMMISSION FINDING.—The finding referred to in paragraph (1) is a finding by the Federal Trade Commission, made after an investigation held under section 4 of the Corporate Community Investment and Jobs Preservation Act of 1984, that a proposed corporate merger will have a substantial adverse effect on employment in a county, city, or other jurisdiction.".

STATEMENT OF HON. BYRON L. DORGAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH DAKOTA

I applaud our Chairman for scheduling these hearings to examine tax aspects of mergers. Last year the mega-deals in the oil and gas industry fueled a 67 percent increase in the reported dollar volume of mergers and acquisitions. Some companies found drilling on Wall Street more profitable than drilling in oil fields. Industry experts expect another torrid round of mergers this year. The deals have gotten increasingly sophisticated—net-operating-loss buyouts, ESOP financed leveraged buyouts—and increasingly tax driven. The question before us is whether it is good public policy for the government to subsidize mergers through the tax code.

These hearings will examine numerous ways in which mergers derive at least part of their rationale through the tax code. An aspect which concerns me the most is the deductibility of interest paid or incurred on indebtedness in connection with large corporate takeovers. I have introduced a bill—H.R. 1553—which would deny this deduction. I am a cosponsor of Mr. Jones' bill—H.R. 1100—which denies the deductibility of interest on hostile acquisitions. Both bills seek to remove the federal incentive for debt financed mergers.

Current law permits profit making corporate acquirers to pay slightly over half of the interest costs incurred in a takeover. The federal government, in effect, pays the rest. This provides an increased incentive to merge, and an increased incentive for mergers to be leveraged. Credit is soaked up, sometimes enormous sums. Last year's purchase of Gulf by Socal, for example, saw a $14 billion line of credit used by Socal. This came to about five times the total farm, business, and real estate credit held by North Dakota's 176 banks. Upward pressure is put on interest rates by merger credit. Huge speculative profits are made—reportedly, Mesa Petroleum netted over $500 million from driving up the price of Gulf stock before its purchase by Socal. Investment bankers take their cut: $47 million from the Texaco-Getty merger alone. The arbitragers have a field day, displaced executives can float into St. Moritz on golden parachutes, and this is all paid for, in part, by the taxpayers.

There are times, certainly, when mergers can make sense. Some mergers can reduce the costs of production where economies of scale exist. They can consolidate technological advances which make obsolete existing production methods or distribution networks.

And there are times when mergers make little sense at all. They can be fiercely anti-competitive. The Seven Sisters of the oil industry will soon be Siamese twins, a result which will neither increase our nation's energy supplies nor decrease prices to consumers.

Mergers are caused by a diverse array of motives, some good, some bad. The question before us is whether American taxpayers should continue to pay a hefty chunk of merger costs. Seagram chief Edgar Bronfman, who was in the thick of the Dupont-Conoco merger, and knows something about takeover wars, said it well, "If the interest on corporate takeover money borrowed * * * were not tax deductible, as it now is, such activity would be sharply curtailed * * * Federal tax revenue would be increased and the * * * taxpayers would thus not be * * * indirectly footing the bill for part of these corporate-takeover games." The benefits or drawbacks of mergers is not the question; it is the subsidation of mergers and acquisitions through the tax code.

THE EMPLOYEE STOCK OWNERSHIP ASSOCIATION,
April 22, 1985.

Hon. J.J. PICKLE,
Chairman, Oversight Subcommittee, House Ways and Means Committee, Washington, DC.

DEAR MR. PICKLE: Because you and your committee will be using the Joint Committee on Taxation Staff's pamphlet on "Federal Income Tax Aspects of Mergers

and Acquisitions" in connection with your hearings on that subject, the Employee Stock Ownership Association respectfully submits this letter as a comment on certain statements in that pamphlet about ESOPs. We ask that our letter be made part of the hearing record, and we have so notified Mr. Dowley of our request.

Our specific comments are as follows:

1. The pamphlet states, "ESOPs are accorded preferential tax treatment under the Code as an incentive to *participation* by employees in their employer" (italic added).

The use of the word "participation" is misleading. Congress' intent in creating ESOP incentives is set forth in Pub. L. 94-455, Sec. 803(h), which provides

"(h) Intent of Congress Concerning Employee Stock Ownership Plans—

The Congress * * * has made clear * * * its interest in encouraging employee stock ownership plans as a bold and innovative method of strengthening the free enterprise system which will solve the dual problems of securing capital funds * * * and bringing about stock ownership by all corporate employees * * *"

Thus, the intent behind ESOPs is to encourage employee *ownership* and to provide a method of corporate finance. Certainly an aspect of ownership is participation, but employee participation may be encouraged by employers without ESOPs.

2. The pamphlet, after citing the provisions of the 1984 Tax Reform Act which provided certain ESOP incentives,[1] sets forth a method by which a corporate raider may use an ESOP to take over a target corporation.

The implication is clear—the 1984 ESOP incentives are exploited by corporate raiders to take over a target corporation in a hostile takeover situation.

The ESOP Association disputes this insinuation. The Association knows of no examples where a corporate raider has utilized any 1984 ESOP incentives to take over a target corporation in a hostile takeover situation. In fact, the Association knows of no situation before the 1984 ESOP incentives involving the takeover of a corporation by a hostile raider. The Association does not pretend to know about every ESOP deal in America, but it does have fairly extensive knowledge of the major ESOP companies.

In other words, the pamphlet's use of the phrase, "In a typical case" to describe the use of ESOPs as a corporate raider's acquisition tool is misleading.

3. The pamphlet states that "Recently, leveraged ESOPs have been used in some situations to thwart hostile corporate takeover attempts."

Although not as misleading as the claim that corporate raiders are using ESOPs, this statement needs clarifying also.

The Association knows of no case since the 1984 ESOP incentives became law where a corporation has successfully defeated a hostile takeover attempt with an ESOP. In both the Phillips and National Can cases, the target corporations tried to fend off hostile takeover offers utilizing, to a degree, an ESOP. Unfortunately, in the view of the ESOP Association, the target companies did not succeed with their ESOP strategy. (The employees would be better off with sizeable ownership in their company than with new owners.)

Prior to the 1984 ESOP incentives, there were examples of a target corporation using an ESOP to help fight off a hostile takeover attempt. Probably the best known case involves Dan River, Inc. But, once again, the examples are few.

It may be stated that, since the 1984 ESOP incentives became law, several corporations, not under an immediate hostile takeover attempt, have engaged in a leveraged buyout of the company with an ESOP, i.e., the employees owning a sizeable part of the corporation after the buyout. It may be that a factor in such a leveraged buyout with an ESOP was the prior owner's or management's fears that the corporation might become a takeover target in the future.

If the Subcommittee wishes to review leveraged buyouts with an ESOP, the Association is more than willing to provide the Subcommittees with information on these transactions.

The Association applauds leveraged buyouts with an ESOP if the stock is valued at a fair price, and the transaction is in accord with Department of Labor and IRS regulations and guidelines.

But, unfortunately, the majority of leveraged buyouts do not involve an ESOP, and result in a greater concentration of corporate ownership.

4. Finally, the pamphlet contains a general statement on the voting rights of ESOP stock.

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[1] Originally introduced as H.R. 5095, 985h Cong. 2nd Sess., which was sponsored by Congressmen Rangel, Downey, among others.

To be more precise than the pamphlet, ESOP stock in a publicly-traded company must be voted by the employees in accordance with the shares allocated to their accounts.

ESOP stock in a privately-held corporation must be voted by the employees in accordance with shares allocated to their accounts on major issues as determined by the securities law of the state in which the corporation is incorporated. Generally, such issues are the same as those involving a hostile takeover attempt, such as mergers, liquidation, or selling the corporation.

When the stock is in a suspense account i.e., it is unallocated, the trustees of the ESOP may vote the stock. (The Association is disturbed by the view of some that the trustees must vote the stock in favor of a takeover bid if the offered price is higher than the market price, without any consideration as to what the corporate raider may do to a corporation after the takeover.)

Your review of this letter is greatly appreciated, and this Association and its over 700 members stand ready to work with your Subcommittee and your staff on any issue pertaining to ESOPs.

Sincerely yours,

J. MICHAEL KEELING, *General Counsel.*

STATEMENT OF HON. KENNETH J. GRAY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr. Chairman, I am pleased to submit the following statement regarding the hearing on the tax aspects of mergers and acquisitions.

I have been following the recent merger and acquisition activities with interest. Certainly, the pace, amount of money being spent, and new debt created has caught my attention. It would appear as if we are in a wave of mergers which may be ominous as there is no apparent balance between national energy goals and the current wave of activity. In other industry sectors we are seeing this same use of capital for what appears to be no productive use. Corporations are being auctioned off for the value of their parts - without regard for what this country needs economically.

As a member of Congress, I have been actively looking to resolve the problem of our national debt, and we continue to search for a solution which will preserve necessary programs and at the same time allow us to bring into line the overwhelming costs of government. It causes concern to see corporation after corporation adding significantly high rates of debt to their accounts at a time when the nation is seeking to move toward more fiscal economy. It takes little effort to see that corporations may be moving in a direction which is inimical to the broader interests of the country.

What makes this trend even more disturbing is the fact that it is being fueled by the merger phenomenon. The increased debt ratios have two very real and disturbing results. The first is the creation of new debt without any increase in productivity; with economic dislocation and stagnation as the real impact on the nation. The second is the recycling of money to the obvious benefit of a few people which in some cases is to the detriment of many. Financial dislocation for many average shareholders brings anxiety, fear, and uncertainty in exchange for compounded growth, stability, and contentment.

Most of these mergers and acquisitions have, of course, occured in the petroleum industry where it is argued the company's shares on the stock exchange are selling below its asset value. The difference in price is, in effect, equity which is being used to finance the takeover activity, reducing the corporation's potential cash for new exploration or other business activities. In other words, raiders are using the target companyies assets to leverage their financing schemes - using up equity necessary to meet the increased energy demands for the nation and its recovering economy.

Congress has chosen, over the last several years, to limit energy production to certain generally well-defined areas, both on and off shore. It has done so in order to preserve the environment. The result, of course, has been increased operating costs. Because of the elasticity of the petroleum marketplace, many of these costs have been absorbed by the corporation and not been passed on to consumers. A survey of retail gasoline prices over the last two years clearly supports this. Also, Congress, in seeking to satisfy our nation's need to reduce the impact of pollution, has looked to large corporations to either help finance or totally finance the clean up of hazardous waste sites, the installation of pollution control devices, and the curtailment of activities in sensitive areas. These demands placed on corporations can only be effective if we have a healthy and prosperous industry.

In reviewing the deficit financing activities of the recent corporate raiders, I have been made aware of the fact that the use of deficit financing is subsidized in part by the Internal Revenue Code which allows for interest deductions. These deductions will, in effect, subsidize the merger activity. Not only does it subsidize the activity in the near term by allowing the deduction of interest for monies borrowed to attempt a takeover, but also in the long term by allowing continued deductions for the long term borrowing by companies who have acquired targets or "bought off" the raider. These deductions not only affect tax revenues which impact on our deficit problem, but also allow expenditures for mergers to be artificially increased.

I believe that Congress' current concern over these activities from the tax, securities, anti-trust, and banking point of view indicates a widespread concern for the negative impacts of what is happening in the corporate marketplace. I endorse your efforts to review the tax aspects of mergers and am hopeful that the result of the hearings will be a consideration to ensure that the tax code is truly neutral in this process and that government subsidies which promote this activity are withdrawn.

STATEMENT OF HON. MICHAEL G. OXLEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. Chairman, I am pleased to have this opportunity to submit a statement in support of your hearings on the impact of mergers and acquisitions.

This current wave of "merger mania" is troublesome. It is not troublesome because I necessarily oppose the merger and acquisition of companies, either through hostile or friendly means, but because it is not clear to me that what is happening in corporate America is, in fact, a merger or acquisition. Even a cursory glance at this recent trend would suggest anomilies to traditional merger and acquisition activities. For instance, the group of people who are initiating the activities, by and large, have failed in their attempts to successfully acquire the target company. In nearly every instance the target managed to survive, albeit in a much different form than prior to the takeover attempt, or has been swallowed up by a third party, a white knight. A second difference is the method of financing these takeovers. Historically, the acquiring company used its own cash reserves and borrowing power plus lending from large commercial banks to assemble a financial package which would succeed in purchasing the target and then melding the target's operations into its own. The current wave of activities is being financed in large part by junk bonds which are by definition highly-leveraged, financial instruments which, in many cases, are backed not by the assets of the acquiring company but by the assets of the target company. A third difference is that in many of the takeover attempts the person putting the company's stock in play is not another company at all but an individual or group of individuals who have been able, through the use of junk bond financing, to assemble a large amount of capital, zero in on the target company stock, churn the market, and wind up making handsome profits for themselves with arguably no regard for the target company.

These differences are disconcerting because they play under a different set of rules from what we have commonly been let to expect. I would argue that perhaps the greatest problem with these "new activities" is the fact that they do not result in the productive use of our capital resources. In fact, there is considerable agreement that the principal beneficiaries of these activities are the people who put the stock in play, and that the principal losers are the U.S. Treasury and the U.S. economy. Two areas where all of us have very singular concerns and responsibilities.

I am familiar with mergers because of the Mobil-Marathon attempt earlier in this decade. I was a first-hand witness to the disruption caused in my district by Mobil's actions toward Marathon and have seen the results of Marathon's ultimate acquisition by U.S. Steel. I am not convinced that Mobil's efforts to put Marathon's stock in play would have resulted in a combination that would have benefited this country, Marathon's employees, or the efficiency we demand from oil producers when we are discussing national energy policy.

My feelings regarding Mobil-Marathon become more intense when I view the current wave of activities among oil companies. As a member of the Energy & Commerce Committee, one of my primary concerns is long-term energy supply for the U.S. It is easy to say that this country runs on energy, but beyond that simple phrase we have to explore precisely what that means. We have hints of the dislocation that can occur when energy supplies are disrupted. The supply and price shocks of 1973–74 and 1979–80 almost brought this country to a standstill. Overseas, in less sophisticated industrial nations, the shocks were even greater and the destabilization created is still being felt today.

As a result of this history, someone has to be concerned about the future of energy in America. This is certainly one of the responsibilities of the U.S. House of Representatives. To this end, when I view the loss or certainly the reduction in competition among the largest oil companies, the tremendous increase in debt, and the dislocation of long-term energy enhancement projects, I fear that we may be undoing our work over the past decade. The search for new supplies of energy is an expensive proposition. The country must have financially strong corporations that can combine technological skill with dollar resources to find the new oil fields and exploit the old oil fields for the benefit of us all. The current dismemberment of these corporations does not auger well toward achieving energy goals. The addition of approximately $13 billion to Chevron's debt, the increase of the debt/equity ration of Phillips to nearly 80 percent, the loss of major oil companies such as Gulf, Cities Service, Getty and Superior all have long-term ramifications which we must explore before the country puts itself in an untenable position from which it will not only be difficult but expensive to recover.

Your hearing on the tax aspects of mergers and acquisitions, I believe, represents a step in the right direction. The Energy Committee has begun a review as well, and I understand that the Judiciary Committee and possibly the Banking Committee will begin their reviews. All of this dialogue tells me that people in Congress are generally uncomfortable with what is happening. When merger and acquisition decisions move away from the realm of the business decision - synergism between companies - into the realm of a financial decision - how much money can we make - then I believe that Congress has an obligation to explore the ramifications of this change. Legislation may or may not be in order. That is what the inquiry should be designed to resolve and that is why I support your efforts. Our concern is certainly the nation's concern and to take these first important steps is in all of our best interests. I applaud you on your efforts and will follow with interest the results of your deliberations.

STATEMENT OF HON. TOMMY L. ROBINSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARKANSAS

Mr. Chairman and distinguished members of the committee: I have followed the events leading up to the proceedings before you with a great deal of interest. More recently, I have become keenly concerned with what has become a recurring spectacle in corporate America. The issues that I believe this Congress should face include the direct impact which takeovers can have on a company's historic operations as well as the social and economic effect on the communities which may have grown up around these companies and their activities.

I am particularly concerned by the assaults on and the acquisition of target companies which have public utility obligations to serve the public. I am gravely concerned about the consequences which successful takeovers, by unrelated investor groups, may have on our nation's energy supply as well as the ultimate downstream impact on consumer utility bills of the huge debt loads being assumed by the major energy producers in efforts to acquire companies or repel raiders.

There have been numerous articles and reports in recent months raising the spectre of energy supply shortfalls as our major domestic energy producers shift from a steady commitment of capital for exploration and development to a total focus on the short-term performance of their company stock. The primary cause of this shift from long-term planning to short-term expediency is not in any way related to corporate or national energy supply (or shortage) projections, company business principles, or the market demand for company product. It is a reaction by company management to a realization that this country, through its recent laissez faire attitudes in all areas of business, including those affecting the national interest, is apparently no longer supportive of the sound principles which have kept us relatively independent from the coercions of OPEC and the supply crunches experienced in Europe. Instead it seems to be every man for himself or his speculative group.

I am not surprised that these raiders have little difficulty convincing banks, savings and loans, and institutional shareholders that the quick buck is patriotic, nor am I surprised at the range of defensive measures target companies employ in attempting to repel these self-serving raiders and their backers.

What I am surprised about is that this Congress is yet unsure whether the issues raised are of sufficient interest to the Nation as a whole to warrant any action on our part.

Corporate raiders piously press their intentions to save companies from passe management while securing just rewards for outside shareholders. Yet, I wonder if any of us here really think that these investor groups will really do anything different once they achieve control, especially after loading the target company with debt. I wonder how many of us really think a Carl Icahn knows how to run an energy company. Or cares to. I wonder how many of us really think that Boone Pickens, with all his expertise in energy, would be allowed by his backers and lenders to con-

tinue a company's business as his first priority, as opposed to first paying them off with the proceeds from liquidated assets.

I wonder how often we reflect on what kind of cash it takes to develop a significant position in energy reserves. Would you believe that five billion dollars can be quickly expended for a new, significant, oil and gas field? Would you believe that half a billion can be spent on drilling equipment to explore harsh environments? Would you believe that when a company is taken over or repels a takeover, such as the one recently involving Phillips, one thing it will be first stripped of is capital for exploration and development? So who does that leave to do the risky exploration and development?

You are all aware, I am sure, of the report issued by the Office of Technology Assessment concerning U.S. natural gas supplies for the remainder of the century. It states that supply shortfall is a real potential due to the role played by tight sand gas, frontier area gas and other known but expensive sources. It is that expense, and the long-term schedule needed for playing out those energy options which I see being jeopardized by our inability to fathom the bottom line of these takeover games.

The community impacts of these takeovers is a vital area, which we, as elected representatives must acknowledge as being in our realm of responsibility. If you think there is no impact or concern, you haven't heard of Bartlesville, Oklahoma, home of Phillips Petroleum, or Findlay, Ohio, home of Marathon Oil, or Pittsburg, Pennsylvania, home of Gulf Oil. The list of such communities is long. The impacts affect every part of our country. I assure you that the concerns of the citizens of these towns were not assuaged by news that the portfolio value of institutional investors would be improved by a takeover. Community ties and neighborhood roots are also American values, as worthy of consideration as some may deem greenmail profits to be.

Finally, I would urge this body to focus on a particular problem. Save for the limited reach of the Public Utility Holding Company Act of 1935, a public utility can be assaulted by raiders, who can then dismember the company when they achieve control. Their customers—who by the nature of the service have no alternative—do not even get the dubious benefit that raiders claim to be conferring on stockholders. Utility customers get no protection whatsoever, and if their company's public service commitment is deemed by the successful raiders to be less important than the quick return, the commitment will be brushed aside. State regulatory bodies can do little effective policing before takeovers have been completed.

I am pleased to say that in Arkansas we have taken some action to protect the quality and cost of our utility service. Last week, Governor Clinton signed into law the Arkansas Hostile Acquisition Review Bill a measure which would give the Arkansas Public Service Commission the authority to scrutinize, in the public interest, whether those who would acquire an Arkansas public utility are prepared to accept the obligations that stewardship requires.

If the raider intends to sell resources that consumers have the right to expect to be dedicated to public service, the acquisition would not be approved. If the raider incurs debts that disable the company from continuing the quality of service Arkansans are entitled to, the acquisition will not go forward.

I commend the Arkansas approach to this Committee, and believe that if Congress fails to come to grips with this problem, it should encourage, and not interfere with, the efforts of the states to do so.

Thank you for the opportunity to present this statement. I appreciate the effort this Committee is expending on this matter.

STATEMENT OF HON. JOHN F. SEIBERLING, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. Chairman, I commend you for calling these hearings to examine the tax aspects of mergers and acquisitions.

As a member of the Judiciary Subcommittee on Monopolies for over 12 years, and as a practicing antitrust lawyer before coming to Congress, I have, for a long time now, watched and worried about the changing nature of merger activity in the business community. It is my feeling that the abuses resulting from unrestrained takeover activity which we are witnessing today among some of our largest corporations may be a significant threat to the continued economic productivity of this nation.

The spectacle of corporate raiders engaging in takeover fights with Fortune 500 companies may provide good copy for business page writers and lucrative deals for manipulators; but for the substantial majority of affected management, sharehold-

ers, employees, pension fund recipients, and local communities, and for the economy as a whole, these corporate war games bring with them the spectre of waste and economic disaster.

Corporate raids have caused fear and an almost obsessive preoccupation with takeovers across the country's boardrooms. Fear of a takeover is now even changing basic corporate operating procedure and strategy. Managers, more concerned than ever with short-term earnings, are, in increasing numbers, sacrificing growth plans that might temporarily affect the price of their stock. They are restructuring themselves, and even "going private," to prevent raiders from doing it for them. To say that such preoccupation with takeover strategy is counter to the traditional American commitment to steady and sure economic growth and planning is understatement. Financial manipulation is threatening to replace competition as the engine that drives our free enterprise system.

If the mergers resulting from these schemes were all beneficial to the economy, that would be one thing. Unfortunately, while some acquisitions may be good for the economy, inducing important efficiencies, that is not always the case. Up to a point, size may bring efficiencies which enhance competition. But big corporations, like big government, carry with them substantial costs. As size increases, the number of decisionmaking centers may be reduced, additional layers of intra-corporate bureaucracy may be imposed, and experimentation and innovation may be impeded. The results of many of the mergers we are witnessing today may include the diversion of scarce capital from productive to unproductive uses, and the distraction of a manager's abilities from competitive to noncompetitive activities. By focusing attention on growth by acquisition rather than on growth by internal investment and expansion, many companies have actually reduced rather than enhanced their own efficiency.

Unfortunately, the Justice Department, the agency charged with overseeing mergers and whether they add to the competitiveness of our economy, has significantly relaxed its enforcement of the anti-merger laws during this Administration. Little has been done in the last four years to deter unsound corporate mergers.

Accordingly, I think it is both appropriate and necessary for Congress to look at the situation and take what action we can to reverse this dangerous trend.

I recognize that many people, especially those within the Administration and the business community, would object to any legislation dealing with merger activity. The market, they argue, should be left free to combine and contract as it wishes. I disagree.

First, it is government's obligation to protect the public interest. I concede that allowing Wall Street to wheel and deal freely may benefit shareholders. But to say that !flonly the interests of shareholders are important is to break almost 100 years of tradition. The Sherman Act was passed in the last of the 19th century as a reaction to financial manipulation. Its goal was to protect consumers and the public interest by ensuring that there exist a sufficient number of competitive entities. That should remain our goal today.

Moreover, it is becoming increasingly clear that today's laws have already played a significant role in shaping a business environment which is conducive to mergers. Federal tax policy especially has had a great influence on industrial concentration and the merger movement. Although on their face the tax laws are neutral with respect to corporate size, in fact they seem to have worked to foster mergers and acquisitions. I believe that there are ways that tax provisions can be structured to remove this pro-merger bias or even to discourage concentration.

One step in this direction would be to deny deductions for interest paid or incurred on loans to finance hostile takeovers or takeovers that violate the anti-merger laws. Current law allows a deduction for corporate interest incurred to finance most acquisitions. An established company may deduct the interest on the money it borrows to buy another company and then use the target company's accumulated earnings to pay the remaining after-tax costs of the merger. Congress should replace this rule with one that offers less inducement to merger activity. Congressman Byron Dorgan has introduced HR 1553 to do this, and I urge the Committee to give it serious consideration.

I also commend to your attention HR 1100, the bill introduced by Congressman Jim Jones, which would deny the interest deduction when a takeover is funded by junior obligation debt, or "junk bonds." This method of financing is so high-risk that once a merger is accomplished, the target company must inevitably be dismembered and the healthy portions of it sold so that the debt can be paid off. How does it help our economy when a once-healthy company is rendered non-competitive in this manner?

Another action that Congress could take to control unsound, uneconomic merger activity would be end the double taxation of dividends. Under current law, earnings are taxed at the corporate level and then again when they are distributed to shareholders as dividends. Retained earnings of the corporation, or increases in the value of its assets, are not taxed as income to the shareholder until he sells his stock. At that time, if he has held the stock long enough, the income he receives from the sale is treated as long term capital gain and taxed at a much lower rate than dividends, which are treated as ordinary income.

Thus, the tax code now helps an acquiring firm buy another using its own accumulated earnings by encouraging corporations to retain earnings rather than distribute them to shareholders. Faced with a pile of retained earnings and the need to invest them profitably, many corporations have turned to the acquisition of going businesses. The pressure to buy is compounded by the desire of shareholders to increase the net worth of the corporation through acquisition so that they may enjoy the tax advantages of capital gains over ordinary income.

One solution to this problem would be to allow corporations to deduct the money they pay out in dividends. This would provide an incentive for corporations to pay out dividends rather than retain earnings and thus cut down on unwise acquisitions. Coupled with this action should be a move to abolish the distinction between capital gains and ordinary income and treat all income, however derived, the same for income tax purposes.

When the Sherman Act was passed in the 1800's, Congress felt that the inevitable result of undue economic concentration was the centralization of power and a consequent loss of confidence in the workings of the market by both the economic participants and the public at large. If the kind of takeover activity we are experiencing today is allowed to get out of hand, our economy could become so concentrated as to threaten the independence of government itself. We should not sit idly by and allow the process to reach that point. The time to act is now.

STATEMENT OF HON. VIRGINIA SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEBRASKA

Mr. Chairman, thank you for giving me this opportunity to present my views on hostile takeover attempts, particularly those involving oil corporations. I commend you for holding this hearing on an issue of importance to the future of the energy industry.

As you know, takeover activity is now proceeding at a feverish pace. Two recent takeover attempts have left Phillips Petroleum $7.3 billion in debt, which makes Phillips the most highly leveraged oil company in the nation. Phillip's primary concern now is to generate cash to reduce that debt, not to make risky investments in oil exploration.

I use Phillips as my example because I regard Phillips as a "constituent" corporation. By that, I mean it is one of the most prominent petroleum companies in the state of Nebraska. Phillips employs 1280 Nebraskans either directly or indirectly, pays around $1.2 million each year in Nebraska taxes, and contributes over $44,000 each year to Nebraska schools, universities, and local United Funds.

Current market conditions make nearly every US oil company vulnerable to hostile takeovers. Energy companies are being forced to extend their long-term debt—not for productive investments in research and development, exploration, or productions—but to purchase stock, thus becoming less vulnerable to corporate raiders. The companies are, in effect, being forced to restrict long-term planning and high-risk investments,

Mr. Chairman, I am concerned that cutbacks in exploration, due to the refinancing either forced by hostile takeovers or the threat thereof, may increase this nation's dependence upon imported oil. A dependable, abundant supply of energy is vital to the agriculture industry. Because agriculture operates on a finely-tuned biological timeclock, it is important that the supply of fuel never be disrupted.

US farmers and ranchers must have gasoline and diesel fuel for the farm machinery used for planting, cultivating, and harvesting. The fleet of 10,000 aircraft, including 900 helicopters, used to spray for insect, disease, and weed control, also need to be supplied with fuel in a timely fashion.

According to the USDA, US farmers and ranchers use about 7 billion gallons of gasoline and diesel fuel per year, in addition to the 1billion gallons of liquefied petroleum used for crop-drying. This total is slightly less than 3 percent of US total consumption, but it is of critical importance.

During much of the energy crises of the 1970's, this nation granted farmers and ranchers an "agricultural priority" that gave preferential treatment to supplying fuel to agricultural producers. This was necessary to ensure that producers had the energy they needed when they needed it. A system of entitlements was worked out whereby small, rural refineries were given the opportunity to buy oil at the same price offered to major refineries.

Natural gas was also included in the "agricultural priority," as another energy source of importance to agriculture. Agricultural industries use almost 3 percent of the natural gas consumed to produce ammonia. Ammonia is a source of nitrogen, the primary plant food element, and is applied to nearly every US crop.

Right now, we have an abundant supply of natural gas. In the past four or five years, however, we have been using natural gas more quickly than we have been finding it. Today's abundance is mainly the result of the deliverability of gas fields found many years ago, and it is vital that we keep searching for new supplies.

Fuel lines that supply rural areas have become another source of concern to the agricultural industry. As a result of the closing of many refineries in rural areas, vast areas of the Midwest are supplied by pipelines stretching from refineries over 1,000 miles away. And when you're at the end of a 1,000-mile supply line, you can count on your supply being tenuous at best.

Mr. Chairman, most of us consider today's oil supplies to be abundant—and they are. However, we are still importing over 30 percent of our oil, which places us in much the same position as we were in the 1970's when OPEC declared its embargo.

Despite record domestic exploration budgets by the US oil industry, production remains flat, and in some years it has taken a slight drop. Our oil and gas reserves have been gradually declining, and the difficulty and cost of finding oil has increased rapidly. I am reminded of the recent exploration activity in Alaska, undertaken at a total cost of about $1 billion, which turned up absolutely nothing.

I am a strong believer in the free market system. Corporation takeovers and mergers are an integral part of the give-and-take of our economic system when used to improve market efficiency. The stockholders of any corporation must have the right to rid themselves of slow-moving, unresponsive management.

But the recent rash of hostile takeover attempts are not actions by those who have a legitimate interest in acquiring a corporation to improve its profitability, but are get-rich-quick schemes by speculators who are taking unfair advantage of provisions in the tax code to reap huge short-term profits.

The current tax code contains a provision which allows an interest deduction for "corporate acquisition indebtedness." The majority of these takeover attempts are being financed by junior obligation debt–high-yield, high-risk bonds that are secured only by the assets of the targeted company. I believe that for economic and tax purposes, these bonds are not debt, but are instruments of equity. For this reason, I favor the expansion of the current provision of the tax code, as provided in HR 1100, to deny an interest deduction when a takeover is funded by junior obligation debt.

Mr. Chairman, in the past two years, we have seen a remarkable change in the energy industry. Long-term debt has risen sharply, not because of production investment, but because companies are worried about a hostile takeover attempt. It is my belief that this trend has negative implications for the energy industry and for the many industries, such as agriculture, that depend on an abundant, reliable energy supply.

Why should our defective tax policies once more expose our economy, particularly our fragile and depressed agricultural sector, to the risk of the tender mercies of the OPEC oil cartel? Let us legislate wisely to avoid unnecessarily overburdening our energy companies and let them do what they have done so well—explore, develop, and produce energy on which our own fabulous economy is squarely based and on which it depends for future growth.

Statement of Hon. Robin Tallon, a Representative in Congress From the State of South Carolina

Mr. Chairman, our corporate sector is suffering from the abuses of the acquisition process by corporate raiders.

Hostile corporate takeover attempts by corporate raiders have no positive impact for the targeted companies or for the overall economy. They result in the lowering of tax revenues for a local economy, liquidation of business operations for target corporations, the loss of thousands of jobs, and a slowing of economic growth. These results are a consequence of the techniques employed by the corporate raiders.

Hostile takeover bids, whether consummated or not, restructure a company's finances, replacing equity capital with debt. The corporate raider uses junior obligation bonds, or "junk bonds," to acquire the company. Those issuing the junk bonds are, in effect, pledging the assets of a company which they do not own. Should the hostile takeover succeed, the targeted company's assets would be used to secure the debt and could be sold to pay off the debt. If the company responds to the takeover bid by buying back the stock from the raider at an overvalued price—a process known as "greenmail"—the company is shackled with a huge debt. The company's indebtedness drains away cash flow for interest payments which otherwise might be used for corporate operations or expansion. Whether the takeover bid "succeeds" or "fails," the company is left in a vulnerable position. The case of the oil industry is instructive.

Salomon Brothers recently compared the 1984 and 1985 spending plans of 18 integrated and 128 independent oil firms. According to their analysis, four recently combined companies, Mobil-Superior, Chevron-Gulf, Phillips-Aminoil and Texaco-Getty all expect to allocate less money to exploration and production this year than their component parts would have. In fact, three of the four indicated they will spend less than they spent in 1984. The cuts amount to hundreds of millions of dollars. The major reason cited was increased indebtedness of the combined firms and their desire to reduce debt levels.

Mr. Chairman, I believe we must address this issue now before any more productive companies are dangerously leveraged by corporate raids. I believe that Rep. Jim Jones's bill, H.R. 1100, provides the best solution to this problem. It gets the government out of the business of underwriting hostile takeover activity without hindering the legitimate movements of capital that are necessary in our free market.

H.R. 1100 effectively closes two major loopholes which corporate raiders use to exploit the tax code for takeovers. It limits corporate acquisition deductions for junior obligation debts, and places a non-deductible, 50 percent excise tax on greenmail profits.

Mr. Chairman, the recent unfortunate history of hostile corporate takeover bids, and the likely continuation of this trend in the future, demands action by the Congress. I would respectfully request that the Committee act expeditiously to report out H.R. 1100 in order to put an end to the use of the tax code to underwrite hostile corporate takeovers.

Statement of the United States League of Savings Institutions

INTRODUCTION

This written testimony is submitted on behalf of the United States League of Savings Institutions,[1] in conjunction with the Committee's examination of the degree to which the Internal Revenue Code influences merger and acquisition decisions. This testimony will focus on the relief measures which were passed in the Economic Recovery Tax Act of 1981 (ERTA) to facilitate mergers of financially distressed thrift institutions. It will discuss the reasons behind that legislation, together with a brief description of the technical rules enacted. The U.S. League believes that the ERTA legislation is accomplishing its stated goals, and that as part of the scope of these hearings it is appropriate to indicate our support for these important merger provisions. The Treasury Department's tax plan, submitted to the President in November, advocates the repeal of the thrift merger provisions of ERTA (Department of the Treasury, *"Tax Reform for Fairness, Simplicity, and Economic Growth"* (November 1984), Vol. 2; Ch. 12.04). In this regard the U.S. League believes the Treasury is wrong and that when the reasons behind these rules are reviewed and their results carefully weighed, it will be apparent that this is not the appropriate time for the Congress to change these rules.

The legislative history behind these ERTA provisions clearly indicates that the Congress was aware that economic conditions then existant were severely affecting

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[1] The U.S. League of Savings Institutions serves the more than 3,500 member institutions which make up the $1.1 trillion savings association and savings bank businesses. League membership includes all types of institutions—federal and state-chartered, stock and mutual. The principal officers include: John B. Zellars, Chairman, Atlanta, Georgia; Gerald J. Levy, Vice Chairman, Milwaukee, Wisconsin; William B. O'Connell, President, Chicago, Illinois; Philip Gasteyer, Executive Director of Washington Operations and Senior Vice President; and James O. Freeman, Senior Vice President, Legislative Representative. League headquarters are at 111 East Wacker Drive, Chicago, Illinois 60601. The Washington office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone: (202) 637-900.

large numbers of savings and loan institutions, and that appropriate relief ought to be granted. Specifically, the staff of the Joint Committee on Taxation noted:

The Congress believed that recent economic conditions, including high interest rates, have had particularly adverse effects on the country's thrift institutions, which have been the primary providers of mortgage credit. These thrift institutions traditionally have engaged in short-term borrowing from their depositors, while lending on a long-term borrowing to their mortgagors. The recent basis high interest rates have required the thrift industry to pay high short-term rates to depositors; at the same time, substantial portions of mortgage portfolios consist of mortgages paying much lower rates. The resulting losses have threatened the viability of thrift institutions.

Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981.* 97th Cong., 1st Sess., 151 (1981) ("Blue Book").

The legislative history demonstrates that Congress was aware that these adverse economic conditions frequently required special assistance from the Federal Savings and Loan Insurance Corporation (FSLIC). In the case of a financially troubled institution, the FSLIC will normally arrange a merger with a more stable institution. In conjunction with these mergers, the FSLIC will at times contribute funds to the acquiring organization as part of the overall plan of reorganization. Prior to 1981, the tax consequences of many of these mergers, together with the tax treatment of the funds contributed by the FSLIC were uncertain. Accordingly, "[t]he Congress concluded that the tax laws should be modified to facilitate providing of financial assistance by the FSLIC and mergers of financially troubled institutions with stronger institutions." (Blue Book, supra, at 152). In Sections 241 through 244, and Section 246 of ERTA, Congress enacted a comprehensive package designed to provide adequate guidance as to the tax effect of FSLIC assistance and mergers of financially troubled thrift institutions.

Three principal areas dealt with in this ERTA legislation should be examined at this point: (1) the tax-free status of mergers of financially troubled institutions; (2) the carryover of net operating losses of the acquired thrift institution; and (3) the tax consequences of the contribution of funds by the FSLIC. In discussing each of these three areas, this testimony will note the tax problem or uncertainty which existed prior to 1981, the specific corrective rule fashioned by the Congress, the sound policy reasons behind the 1981 legislation, and finally the continuing need for these important supervisory merger rules.

TAX-FREE STATUS OF MERGERS OF TROUBLED THRIFT INSTITUTIONS

In order to qualify as a tax-free reorganization as defined in Section 368 of the Code, the continuity of shareholder interest requirement provides that the shareholders of the acquired corporation must receive an amount of stock in the acquiring corporation representing a significant continuing interest. This is a nonstatutory requirement crafted by the courts, which has been subsequently incorporated by the Treasury Department into the Income Tax Regulations. The purpose of this requirement is to provide a mechanism for distinguishing between exchanges where nonrecognition is appropriate since the former shareholders of the acquired corporation have substantially continued their investment in the acquiring corporation by taking stock of the acquiring corporation, and exchanges where the shareholders of the acquired corporation should not be entitled to nonrecognition since they have essentially "cashed out" their former investment.

Under the reorganization rule existing prior to the ERTA amendments, the application of the continuity of shareholder interest requirement to reorganizations where a stock savings and loan was merged into a nonstock mutual thrift institution was unclear. The Internal Revenue Service has ruled in Rev. Rul. 69-6 (1969-1 C.B. 104) that such an exchange violated the continuity of interest requirement since the shareholders of the acquired stock savings and loan did not receive any stock in the mutual savings and loan. Therefore, the view of the Service was that these exchanges were taxable. However, the lower Federal courts which had considered this question has held that such transactions could qualify as reorganizations. *See Capital Savings and Loan Association v. U.S.*, 607 F.2d 970 (Ct. Cl. 1979); *Westside Federal Savings and Loan Association v. U.S.*, 494 F.2d 404 (6the Cir. 1974): and *Everett v. U.S.*, 448 F.2d 357 (10the Cir. 1971). The United States Supreme court in *Paulsen v. Commissioner* (53 U.S.L.W. 4029 (1985)), has recently declined to follow the opinions of these other Federal courts and affirmed the contention of the Service that mergers of stock savings and loans into mutual savings and loans are taxable events. These lower Federal courts and the two Justices who dissented in *Paul-*

sen believed the continuity of interest requirement erected an unfair disparity between acquisitions made by stock institutions and mutual institutions.

The requirements of Section 368(a)(1)(G) of the Code, prior to ERTA, created another barrier to the acquisition of insolvent thrifts. This is because that Section requires shareholders or security holders to receive stock of the acquiring entity as a condition for favorable treatment. Although the term "security" is not precisely defined in the Code, it can be generally stated that a debt must have a term in excess of five years to be considered a security in this regard. In insolvencies, the equity holders (depositors in the case of a mutual thrift, or shareholders in the case of a stock thrift) of the acquired thrift will not be entitled to receive any stock of the acquiring institution. Because the balance sheets of thrift institutions do not typically include long-term debt (such as debentures) which constitute securities under the above definition, these financial institutions did not have other creditors who could receive stock to satisfy the requirements of the Code. Accordingly, such institutions were practically barred from the tax treatment available to business corporations.

If the merger of a thrift institution does not qualify as a tax-free reorganization, there are several resultant adverse tax consequences. First, the shareholders of the acquired thrift institution must recognize gain (or loss) on their stock. Second, and more importantly in insolvent mergers, the acquired thrift institution must recognize the gains or losses inherent in its assets on the transfer of such assets to the acquiring thrift institution. Third, the basis of the mortgages in the hands of the acquiring thrift institution will take a current cost basis. Since this basis generally would be substantially below face value in a situation where interest rates have risen, repayments of principal will result in taxable income to the acquiring corporation, though amortization of any goodwill would not be deductible. Fourth, as discussed below, the acquiring corporation will not be able to obtain the benefits of any net operating losses of the acquired institution.

The Congress enacted Section 368(a)(3)(D) in 1981 in response to the problems set forth above. Section 368(a)(3)(D) provides that in an agency proceeding involving a financially distressed thrift institution, a transaction otherwise qualifying as a reorganization within the meaning of Section 368(a)(1)(G) will not be disqualified as a reorganization even if no stock or securities of the acquiring thrift institution are received by the shareholders of the acquired savings and loan. An agency proceeding is one involving the Federal Home Loan Bank Board (FHLBB), the FSLIC, or if neither has supervisory authority with respect to the acquired thrift institution, then the equivalent state authority. The rules set forth in Section 368(a)(3)(D) are carefully designed to ensure that relief from the continuity of shareholder interest requirement will only be extended to situations where all of the assets and liabilities of the troubled institution are acquired, and where the transaction is an agency proceeding in accordance with the banking laws of the United States (12 U.S.C. Section 1464(d)(6)(A)(i), (ii), or (iii)). Therefore, as a result of this amendment to Section 368, the acquired institution will not recognize any gain or loss with respect to the transfer of its assets, and the acquiring institution will obtain a carryover basis in all of the assets of the acquired institution.

In the case of insolvent acquired thrifts, the stock issuance waiver of Section 368(a)(3)(D)(ii) cleared the way for reorganization status in situations where there is literally no equity to distribute.

Section 368(a)(3)(D)(i)(II) states that in the case of a mutual savings bank or building and loan association, the agency having jurisdiction will be treated as a court, thereby providing access to the reorganization rules of Section 368(a)(1)(G). By allowing troubled thrifts to by-pass the Title 11 route, the Congress shaved years off the time necessary to accomplish a reorganization of a troubled thrift. This salutary provision has resulted in increased investor, depositor, and creditor confidence in the savings and loan industry. The recent problems in Ohio show the importance of smooth resolution of problem cases to the maintenance of that public confidence which is essential to the depository system.

The problems perceived by the Congress in 1981 remain problems in 1985. The recent Treasury plan errs when it refers to the 1981 legislation as assistance only to the "then-ailing thrift industry". Thrift institutions still have a significant spread between the interest earned on portfolios of long-term fixed rate mortgages and current market yields. Thrift institutions are particularly subject to volatile shifts in the capital markets, and are still only part-way through the restructuring of their balance sheets to cope with a more uncertain, competitive and deregulated environment. Section 368(a)(3)(D) was crafted to ensure that its relief provisions would only apply in situations where the imposition of tax and the denial of carryover basis would result in a substantial hardship to the acquired corporation, its shareholders,

and the acquiring corporation. Accordingly, Congress should preserve these rules and thereby continue to provide their limited but necessary benefits.

NET OPERATING LOSS CARRYOVERS

If the acquisition of the assets of one corporation by another does not qualify as a reorganization described in Section 381(a)(2), the tax attributes (including net operating loss carryforwards) of the acquired corporation completely disappear. By removing the stock issuance impediment discussed above, Congress enabled acquisitions of financially distressed thrifts to qualify as reorganizations. However, since the acquiring corporation will not be issuing stock in the reorganization, the application of the existing rules of Section 382(b) of the Code necessitated a concomitant change. Section 382(b)(1) provides that in the reorganization of a corporation which has a net operating loss carryover, the shareholders of the loss corporation, as a result of owning stock in the loss corporation, must subsequently own twenty percent of more of the fair market value of the outstanding stock of the acquiring corporation, or the net operating loss carryover will be scaled back in accordance with the rules of Section 382(b)(2). Thus, in a situation where a mutual savings and loan acquired the assets of a stock savings and loan or where an insolvent thrift was acquired prior to 1981, there would be a complete elimination of the net operating loss carryover since the former owners of the acquired corporation would not be receiving any stock.

To correct this, Congress provided a special rule in 1981 by enacting Section 382(b)(7)(B). There are three components of this special rule. First, the rule provides that in a transaction qualifying under Section 368(a)(3)(D)(ii), a depositor in the transferor corporation shall be treated as a stockholder immediately before the reorganization. Second, deposits in the transferor which become, as a result of the transfer, deposits in the transferee will be treated as stock of the acquiring corporation acquired as a result of owning stock in the loss corporation. Third, the fair market value of the outstanding stock of the acquiring corporation will include the amount of deposits in the acquiring corporation immediately after the reorganization. This special rule therefore enables the acquiring corporation to obtain the benefit of the net operating loss carryforward of the acquired thrift institution even in situations where a mutual savings and loan acquires the assets of a stock savings and loan.

It is important to note that in enacting the special rule of Section 382(b)(7)(B), the Congress did *not* permit any trafficking in net operating losses of distressed thrift institutions. This is apparent for two reasons. First, the thrift acquisition remains subject to the twenty percent rule of Section 382(b)(1), together with all other reorganizations. The special rule of Section 382(b)(7)(B) merely provides an effective method of measuring the ownership interest received in an acquiring mutual savings and loan, and does not provide any waiver of the rules applicable to reorganizations generally. Second, the legislative history states that Section 269 of the Code, which deals specifically with acquisitions having as their principal purpose the evasion or avoidance of federal income taxes by trafficking in net operating losses, continues to apply to the acquisition of financially distressed thrift organizations. The possible abuse through trafficking in net operating loss carryforwards of distressed thrift institutions is further minimized by the fact that this special rule only applies in agency proceedings where the FHLBB, the FSLIC, or the relevant state authority is involved in arranging the acquisition.

SECTION 597 ASSISTANCE PAYMENTS

Prior to the enactment of Section 597 in 1981, the tax treatment of payments and other assistance by the FSLIC to thrift institutions was uncertain. The assistance given by the FSLIC may occur in three contexts: (1) direct financial assistance to financially distressed thrift institutions; (2) contributions made to such institutions where the thrifts issue to the FSLIC Income Capital Certificates or Net Worth Certificates (which are a hybrid between traditional debt and equity securities); and (3) contributions to acquiring thrift institutions in connection with agency-arranged acquisitions of troubled thrifts.

Section 597(a) of the Code now provides that the gross income of a domestic building and loan association does not include any amount of money or other property received from the FSLIC in certain special situations, regardless of whether any note or other instrument is issued in exchange therefor. Section 597(b) provides that no reduction in the basis of assets of the receiving association will be made on account of money or other property received under the circumstances referred to in Section 597(a) of the Code. The Congress also provided that the recapture rule for distributions out of excess bad debt reserves provide in Section 593(e) does not apply

to distributions to the FSLIC in redemption of an interest in a thrift institution which had been received in exchange for financial assistance. This treatment, however, does not extend to distributions not in redemption (for example, payments of interest to the FSLIC).

The argument has been made that the benefits provided by Section 597 are overly generous. However, for three reasons it is respectfully submitted that they are not. First, Section 597 legislatively resolved several difficult legal issues surrounding the proper tax treatment of such payments, which would have required a large and unproductive expenditure of time and money on the part of both taxpayers and the government to resolve ultimately: certainty, as a goal of sound tax policy, was advanced by the enactment of Section 597. Second, Section 597 is a provision designed to provide assistance to an industry deemed worthy of assistance by the Congress. In a similar vein, Congress has provided that regulated public utilities may receive contributions in aid of construction without current inclusion in income pursuant to Section 118(b), while at the same time not being required to reduce the basis of other property on account of the money or other property received under Section 118(b) by reason of the special rule of Section 362(c)(3). It should be noted that the Treasury plan does not call for a similar repeal of Sections 118(b) and 362(c)(3). Third, the cost of foregoing current inclusion in income and not requiring a reduction in the basis of other assets is relatively small when considered in the overall economic picture. The cash assistance provided under Section 597 is never sufficiently large enough to fully return the acquired institution to financial health. Such assistance is merely a small part of the inducement to the acquiring institution to take over such a problem institution. If these sections of the Tax Code are eliminated, the supply of healthy merger candidates will simply evaporate and the FSLIC will have no option but wholesale liquidations. Such liquidations would be extremely expensive. Currently a problem case is typically handled by merger at between 5% and 20% of the costs of liquidation. FSLIC expenses, at a time of extreme financial fragility, would be increased substantially by elimination of these sections. At the very least, FSLIC outlays would rise by half and could easily double or triple. Even with the beneficial tax changes made in 1981, FSLIC outlays have risen substantially since that year and are projected to increase further even assuming the preservation of these special provisions. The combined direct and indirect costs to the government of allowing troubled thrift institutions to founder greatly outweighs the aggregate Treasury cost of Section 597 tax assistance.

CONCLUSION

In conclusion, Mr. Chairman, and Members of this Subcommittee, the U.S. League would like to state that the 1981 legislation was a laudable and necessary effort on the part of the Congress to provide continued stability to thrift institutions which have been the mainstay in providing affordable home mortgages in America. The economic difficulties which prompted this 1981 legislation continue to have a substantial impact on savings and loan institutions.

Though the number of FSLIC-assisted problem mergers has receded somewhat from the peaks of 1981 and 1982 those FSLIC actions represent a much higher proportion of total merger activity. In addition, as asset quality problems have comprised a much larger share of the caseload, the number of FSLIC liquidations has actually risen sharply. In 1982, the FSLIC handled its total caseload of 74 mergers with only one liquidation: In 1984, 9 of the 27 cases had to be handled by liquidation, a significant fraction of all FSLIC liquidations in the fund's 50-year history occurring in that one year. Though the total assets involved in 1984 at $5.7 billion made up only a fifth of the 1982 level of $28.3 billion, the costs did not shrink proportionately. Any changes in the tax law which would produce a higher likelihood of liquidations would have a very severe impact on the FSLIC. The problems of the fund and the industry it insures have not yet dissipated. These exigent situations will continue to require FSLIC assistance and agency-supervised mergers of troubled thrifts. The tax uncertainties which existed prior to 1981 could return if these laws are repealed or substantially amended. We therefore respectfully request the Congress to preserve these important and still very needed thrift supervisory merger provisions fashioned in the Economic Recovery and Tax Act of 1981.

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